CA Final – Advanced Auditing & Professional Ethics

MODULE IV

Different Types of Audit

Must Read - Preface to Revised Module IV – Different Types of Audit

The entire syllabus of Module IV has been classified into 9 chapters as explained in the content sheet. The main features of revised module are:

- Contents in tabular form with point wise details.
- Previous Years Questions after end of every topic.
- Coverage of repetitions of the questions in the exams enabling the students to identify the important questions.
- Graph of Marks distribution, attempt wise at the end of every chapter.

Important feature about the contents of this module is that it covers around **30 Marks** in the exams. Analysis of previous years questions clearly reflects that most of the questions asked in New Syllabus (Since Nov. 08) are repetitions of questions asked in previous year exams.

Hence due weightage needs to be given to this module as it will cover around 30% of Question Paper. The marks analysis of different chapters attempt wise is given below:

Marks Analysis of Different Topics

	CIS Audit	Cost audit	Operational Audit	Tax Audit	Audit of CFS	Investigation	Peer Review	Sox audit	Misc.	Total
Nov. 10	8	4	5	5	0	5	0	5	0	**32**
May 10	0	4	0	5	0	0	3	0	0	**12**
Nov. 09	8	0	0	12	0	0	4	8	0	**32**
May 09	0	0	0	16	8	0	4	0	4	**32**
Nov. 08	8	0	0	4	0	4	4	4	12	**36**
Average	4.8	1.6	1	8.4	1.6	1.8	3	3.4	3.2	**28.8**

I hope that readers will be satisfied with the contents of these notes. Still, there always remains scope for improvement. I will be grateful to the readers for their valuable feedback for improvement of these notes.

Wishing every success to the readers.

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Best of Luck…………….

CONTENTS

TYPES OF ACCOUNTING SYSTEMS

Processing Systems	***Batch Processing Systems***	In batch processing system, the transactions are accumulated and processed in a group. ***Steps in batch processing***: 1. *Occurrence of transaction* - Occurrence of business events is recorded in the source document. 2. *Recorded in a Transaction file* - A batch of source document is periodically transferred to the data entry operator to extract information from the source document and enter it into the computer for processing. 3. *Updation of Master file*: After data entry is done and processed, the master files are updated. 4. *Generation of output*: After processing and master file updation, the report, as required are periodically generated. ***Advantages of Batch processing system***: • Relatively Simple and Reliable. • Can be used for processing volumes of repetitive transactions. • Existence of Audit Trail. ***Limitations of Batch processing system***: • They do not process transactions as quickly as the more advanced systems • Non availability of information timely.
	On Line Real Time Processing Systems	In this system transactions are entered as they occur and are processed as they are entered. ***Characteristics of OLRT Processing system***: 1. *Validation Checks*: When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. 2. *On-Line Access:* Users may have on-line access to the system that enables them to perform various functions. The extent of this access will depend upon such things as the design of the particular application and the implementation of software designed to control access to the system. 3. *Transaction Trail:* An on-line computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request. 4. *Programmer Access*: Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted access provides the programmer with the potential to make unauthorised changes to programs and obtain unauthorised access to other parts of the system. ***Advantages of OLRT System***: • Processing of transactions as and when occur. • Continuous updation of database. ***Limitations of Batch processing system***: • Non availability of audit Trail • Relatively More Complex

	Time Sharing	Where a computer serves more than one person, there occurs timesharing.
	Service Bureau Processing	Here an outside entity is hired to process the transactions of the business.
File Systems	***Flat File systems***	• In this system, the user has exclusive access to and use of his set of data. • It lead to wastage of memory space as many users may save the same data.
	Integrated Database System	• This system contains a set of inter related master files that are integrated in order to reduce data redundancy. • This system is generally combined with On-Line real time Processing System.

<u>Previous Year Questions</u>

Q. No. 1: "On-line real time processing system and batch processing system have their inherent strengths and weaknesses." Comment. [Nov. 01 (8 Marks)]

Q. No. 2: What are the characteristics of 'On-line Computer System'. [Nov. 04 (4 marks)]

Q. No. 3: You have been approached by an organization to suggest a system where the user wants to access data immediately. What would be your suggestions if they want to process it after validation? [May 10 – Old (8 Marks)]

Characteristics of CIS Environment / Factors to be considered in understanding CIS Environment	
Lack of transaction trails	• It increases the risk of auditor as errors embedded in an application's program logic may be difficult to detect on a timely basis by manual procedures.
Uniform processing of transactions	• Elimination of clerical errors ordinarily associated with manual processing. • But programming or other systematic errors may arise.
Lack of segregation of function	• Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. • Thus, an individual who has access to computer programs, processing or data may be in a position to perform incomplete functions.
Potential for errors and irregularities	• Potential for human error in the development, maintenance and execution of CIS may be greater than in manual system.
Automatic execution of transactions	• CIS may include the capability to execute certain types of transactions automatically. • Management's authorization of these transactions may be implicit in CIS design.
Dependence of other controls over computer processing	• Computer processing may produce reports and other output, that are used in performing manual control procedures. • The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing.
Potential for increased management supervision	• CIS can offer management a variety of analytical tool that may be used to review, supervise and enhance entire internal control structure.
Potential for the use of CAAT)	• In case of processing and analysis of large quantitative of data using computers, may require the use of specialized computer audit techniques and tools in the execution of audit tests.

Previous Year Questions

Q. No. 4: "When the computer information systems are significant, the auditor should obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risk". What factors an auditor has to consider in such risk assessment? [June 09 – Old (12 Marks)]

Internal Controls in Computer Based System

General CIS Controls	The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved.	
	Organisation and management controls	(i) Policies and procedures relating to control functions. (ii) Appropriate segregation of incompatible functions.
	Application systems development and maintenance controls	(i) Testing, conversion, implementation and documentation of new or revised systems. (ii) Changes to application systems. (iii) Access to systems documentation (iv) Acquisition of application systems from third parties
	Computer operation controls	(i) The systems are used for authorised purposes only. (ii) Access to computer operations is restricted to authorised personnel. (iii) Only authorised programs are used. (iv) Processing errors are detected and corrected.
	Systems software controls	(i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications. (ii) Restriction of access to systems software and documentation to authorised personnel.
	Data entry and program controls	(i) An authorisation structure is established over transactions being entered into the system. (ii) Access to data and programs is restricted to authorised personnel.
CIS Application Controls	The purpose of CIS application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis	
	Controls over input	(i) Transactions are properly authorised before being processed by the computer. (ii) Transactions are accurately converted into machine readable form and recorded in the computer data files. (iii) Transactions are not lost, added, duplicated or improperly changed. (iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.
	Controls over processing and computer data files	(i) Transactions, including system generated transactions, are properly processed by the computer. (ii) Transactions are not lost, added, duplicated or improperly changed. (iii) Processing errors are identified and corrected on a timely basis.
	Controls over output	(i) Results of processing are accurate. (ii) Access to output is restricted to authorised personnel. (iii) Output is provided to appropriate authorised personnel on a timely basis.
Other Safeguards	(i) Offsite back up of data and computer programmes. (ii) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction. (iii) Provision for Offsite processing in the event of disaster.	

Problems in Implementation of Internal Control in CIS Environment

Separation of duties	• In a manual system, separate individuals are responsible for initiating transactions, recording transactions and custody of assets. Due to automation in the system, such controls are not possible in a computer system.
Delegation of Authority and responsibility	• Due to use of resources by multiple user, it becomes difficult to delegate authority and responsibility in a precise manner. For example, as many users access the database, it may not be possible to trace the person making unauthorized changes in it.
Competent and Trustworthy persons	• Organisations find it difficult to find and retain competent and trustworthy personnel to take charge of their EDP set up.
System of authorisation	• As against the manual system, automation of the authorization procedure is an important feature of EDP System. For example, the computer system may determine the price to be charged to customers. Thus the auditor has to verify the veracity of computer processing.
Adequate documents & records	• In computer systems, documents may not be used to support the initiation execution and recording of some transactions. Thus, no visible audit trail may be available.
Physical control over assets and records	• As the data processing assets and records are concentrated at a place, the risk of loss and unauthorized access is high.
Adequate management supervision	• In computer systems, data communications may be used to enable the employees to be closer to the customer they service. Thus supervision of employees may have to be carried out remotely.
Comparing records with physical assets	• Unlike in manual system, the records may be automatically reconciled with the assets. Thus unauthorized modifications to programs or data files that these programs use, may be difficult to detect.

Previous Year Questions

Q. No. 6: State the specific problems, which may arise in the implementation of internal control in an EDP system. [Nov. 04 (8 marks)]

Controls to be evaluated by Auditor in CIS Environment

(A) Review of Controls operating over date moving into, through and out of the computer

1. **Organisation structure and control**	• Examine the responsibilities of each job position w.r.t. CIS function and ensure that the person understands the duties, authority and responsibilities. • The duties have to be separated to ensure the internal control is established.
2. **Documentation Control**	• Ensure existence of proper and adequate documentation for approval of system flowcharts, Programme flowcharts, Programme changes, etc.. • Changes made in the above are also documented & and approved by authorized persons.
3. **Access Control**	• Ensure that the system restricts the persons to access restricted data. • Ensure that the system denies access to unauthorized persons.
4. **Input controls**	• Ensure that only properly authorized and approved data goes in the input. • Examine validation controls
5. **Processing controls**	• These controls are must for integrity of data. • Processing validation checks should be applied.
6. **Recording Controls**	• To enable the records to be kept free of errors.
7. **Storage Controls**	• Examine Back up and recovery facilities to ensure the proper data availability to the management.
8. **Output controls**	• The data processed must go to the authorized person in the required manner. • Examine whether the audit trail relating to output is provided.

Previous Years Questions

Q. No. 5: Different types of controls which operate over date moving into, through and out of the computer. Auditor is required to review such control. Comment. [Nov. 10 – New (8 Marks)]

(B)	**Major Clauses of Controls to be evaluated**	
	1. Authenticity Control	They are exercised to verify the identity of the individuals or process involved in a system. For example: use of Password, Digital Signature etc.
	2. Accuracy Control	It ensures the correctness of the data and processes in a system (Validation Check).
	3. Completeness Control	This ensures that no data is missing and all processing is carried through.
	4. Privacy Control	This ensures the protection of data from unauthorised disclosure.
	5. Audit Trail Controls	This ensures the traceability of all events occurred in a system.
	6. Redundancy Control	It ensures that processing of data is done only once.
	7. Existence Control	It attempts to ensure the on going availability of all system resources.
	8. Asset Safeguarding controls	It attempts to ensure that all resources within a system are protected from destruction or corruption.
	9. Effectiveness Control	It attempts to ensure that the system achieves its goals.
	10. Efficiency Control	It attempts to ensure that a system uses minimum resources to achieve its goals.
	Previous Year Questions ***Q. No. 7***: The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability – Comment. [Nov. 08 – New (8 Marks)]	

Audit Trail

Meaning	Audit trail refers to the facility to trace individual transactions through system from source to completion. In the manual system of accounting, the audit trail is distinct and can be followed by the auditor through the distinct stages of accounting process. However, in computerized system audit trail is often missing or is sketchy. A proper audit trail ensures audit checking for proper processing and accumulation of data.
Reasons for non existence of audit trail in CIS	1. Source documents once transcribed in machine readable form are not retained in a manner that permits subsequent access. 2. Master files may replace ledger summaries. 3. Transaction listing is often not provided. 4. Reports may be only on exceptions.
Remedies for non-existence of audit trail	The auditor may adopt below mentioned techniques to verify computerized data in case of loss of audit trail: 1. Examination of computer Program 2. Use of test packs, and 3. Use of computer audit programs for different audit purposes.

Computer Assisted Audit Techniques

Meaning	CAAT refer to those auditing techniques that take assistance of a computer for being applied to an audit in a computer environment.
Need for CAATs	The use of CAATs may be required because: • absence of input documents; • generation of accounting transactions by computer program; • the lack of a visible audit trail; and • the lack of visible output. CAATs enable the auditor to save time by examining data stored on computer media rather than on print-outs or other documents and, in some cases, to conduct tests which cannot be done manually because there is no visible evidence or audit trail.

<table>
<tr><td>Uses of CAATs</td><td colspan="3">CAATs can be used for both compliance and substantive testing. CAATs may be used in performing various auditing procedures, including:
(i) <u>Tests of details of transactions and balances</u> for example, the use of audit software to test all (or a sample) of the transactions in a computer file.
(ii) <u>Analytical review procedures</u> - for example, the use of audit software to identify unusual fluctuations of items.
(iii) <u>Compliance test of general EDP controls</u> - for example, the use of test data to test access procedures to the program libraries.
(iv) <u>Compliance tests of EDP application controls</u> - for example, the use of test data to test the functioning of a program procedure.</td></tr>
<tr><td rowspan="5">Commonly Used CAATs</td><td rowspan="4">Audit Software</td><td colspan="2">Audit software consists of computer program used by the auditor as a part of his auditing procedure to process data of audit significance. It may consist of:</td></tr>
<tr><td>Package programs</td><td>• These are generalised computer programs designed to perform data processing which includes reading computer files, selecting information, performing calculations, creating data files and printing reports in a format as specified by the auditor.</td></tr>
<tr><td>Purpose written programs</td><td>• These are computer programs designed to perform audit tasks in specific circumstances.
• These programs may be prepared by the auditor, by the organisation or by an programmer engaged by the auditor.</td></tr>
<tr><td>Utility programs</td><td>• These are used by the organisation to perform common data processing functions, such as sorting, creating and printing files.
• These programs are generally not designed for audit purposes.</td></tr>
<tr><td><u>Test Data</u></td><td colspan="2">Test data techniques are used in conducting audit procedures by entering data into the computer system of the organisation and comparing the results obtained with pre-determined results. For example:
• Test data used to test specific controls in computer programs, such as, on line password and data access controls.
• Test transactions selected from previously processed transactions preferably historical data or data treated by the auditor to test specific processing characteristics of the organisation's computer system. Such transactions are generally processed separately from the entity's normal processing.
• Test transactions used in an integrated test facility where a 'dummy' unit is established and to which test transactions are posted during the normal processing.
When test data is processed with the organisation's normal processing the auditor should ensure that the test transactions are subsequently eliminated from accounting</td></tr>
<tr><td rowspan="3">Considerations in the Use of CAATs</td><td colspan="2">1. Availability of sufficient IT knowledge & expertise</td><td>It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT.</td></tr>
<tr><td colspan="2">2. Incompatibility between CAATs and computer facilities</td><td>Auditor may plan to use other computer facilities when the use of CAATs on an entity’s computer is uneconomical or impractical, e.g. incompatibility between audit program and entity’s computer.</td></tr>
<tr><td colspan="2">3. Impracticability of manual tests</td><td>Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure.</td></tr>
</table>

	4. Impact on effectiveness & efficiency in extracting a data	It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.
	5. Time constraints	In certain data, transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.
Using CAAT in Small Business Organizations	Following points should be kept in mind in case of small business organizations. . 1. The level of general I. T. controls may be such that the auditor will place less reliance on system of internal controls. Thus he will emphasize on substantive procedures. 2. As transactions processed are comparatively lower, manual methods may be more cost effective. 3. Use of CAATs may become impracticable, due to lack of technical assistance with the entity,. 4. The audit packages may not operate on small computers.	

Previous Years Questions

Q. No. 8: Write short notes on - Factors to consider in determining the use of CAAT. [May 07 (4 Marks)]

Q. No. 9: "Use of Audit Software would increase the probability of detecting frauds". Comment. [May 08 (6 Marks)]

Control Procedures while Using CAAT	***Control Audit Software Application***	(a) Participating in the design and testing of the computer programmes. (b) Checking the coding of the programme. (c) Requesting the entity's computer staff to review the operating system instructions to ensure that the software will run in the entity's computer. (d) Running the audit software on small test files before running on the main data files. (e) Ensuring that the correct files were used. (f) Obtaining evidence that the audit software functioned as planned. (g) Establishing appropriate security measures to safeguard against manipulations of the entity's data files.
	Control Test Data Applications	(a) Controlling the sequence of submissions of test data where it spans several processing cycles. (b) Performing test runs containing small amounts of test data before submitting the main audit test data. (c) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total. (d) Confirming that the answered version of the programmes was used to process the test data. (e) Obtaining reasonable assurance that the programmes used to process the test data were used by the entity throughout the applicable audit period.

Previous Year Questions

Q. No. 10: Discuss the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under EDP environment. [Nov. 03 (8 Marks)]

Characteristics of Computer Audit Program	***1. Simplicity***	The system should be simple to use & eliminate the need for remembering countless details normally required in writing computer programs.
	2. Understandability	• The system should be readily understandable by members of the audit staff, even those with little computer expertise. • The capabilities of the system should be known & should be easy to use.
	3. Adaptability	The system should be capable of writing computer audit programs for the various types of computers used in the company or expected to be acquired.
	4. Vendor technical support	• Initial installation • Adequate documentation. • Training to audit staff. • Provision for future revisions in the programs.
	5. Statistical sampling capability	• Selection of items on a random basis, • Determination of sample size, and • Evaluation of results at different confidence levels.
	6. Acceptability	• System should be acceptable to both - auditors and computer centres. • For the auditors the programs should be easily carried to the site and practical to use. • For the computer centre the programs should be compatible with the system and be capable of minimum interference with normal routines.
	7. Processing Capabilities	• Ability to process many different types of applications. • Capability for extended data selection and stratification. • Ability to operate under multiprogramming situations.
	8. Report Writing	• Ability to prepare multiple reports in a single program run • Generate flexible output report formats.

Previous Year Questions

Q. No. 11: State the important characteristics of an effective system of Computer Audit Programme.

[Nov. 06 (8 Marks)]

COLLECTION AND EVALUATION OF AUDIT EVIDENCES

Changes to Evidence Collection	Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system due to the following reasons: (a) Existence of diverse and complex range of internal control technology that did not exist in manual system. (b) Rapid developments in Hardware and Software technology. (c) Cryptographic controls to protect the privacy of data. (d) Collection of audit evidence through manual means is not possible. With these limitations, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available, the development of these tools cannot be relied upon due to lack of information. Hence auditors are forced to compromise in some way when performing the evidence collection.

Changes to Evidence Evaluation	In an CIS environment it becomes more difficult for the auditors to evaluate the evidences due to following reasons: (a) Increasing complexity of computer systems and control technology. (b) In a shared data environment a single input transaction may update multiple data item used by various users may be difficult to understand. (c) Consequence of errors in a computer system is a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. (d) Errors are generated at high speed & the cost and effort to correct and rerun program may be high. Under these circumstances, there is requirement of internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

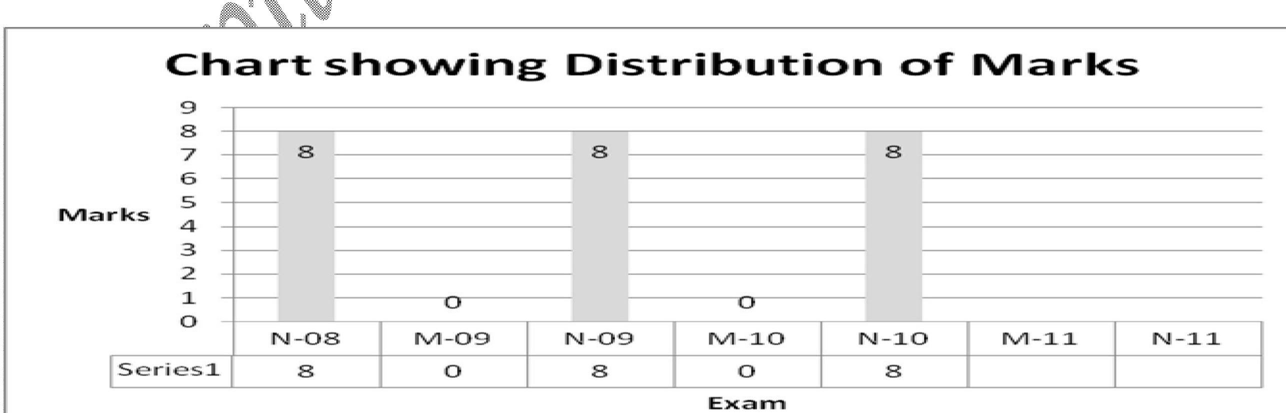
Previous Years Questions

Q. No. 12: "The method of collecting Audit evidence and evaluating the same changes drastically under EDP Auditing". Comment on the above. [Nov. 07 (8 Marks)]

Q. No. 13: The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss. [Nov. 09 – New (8 Marks)]

MISCELLANEOUS

Tagging and Tracing	• It is a technique better than Integrated Test Data Facility. • It involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries' test data designed under Integrated Test Data Facility does not arise. • The hard copy, so produced is available only to the auditor and may describe such inputs as hours worked in a pay period in excess of 50; or sales orders processed in excess of Rs.1,00,000. • This enables the auditor to examine transactions at the intermediate steps in processing. • The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. • The disadvantage is that the erroneous data will not necessary be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.
	Previous Years Questions ***Q. No. 14***: Explain : Tagging and Tracing [Nov. 04 (4 Marks)]



Chapter – 2 COST AUDIT

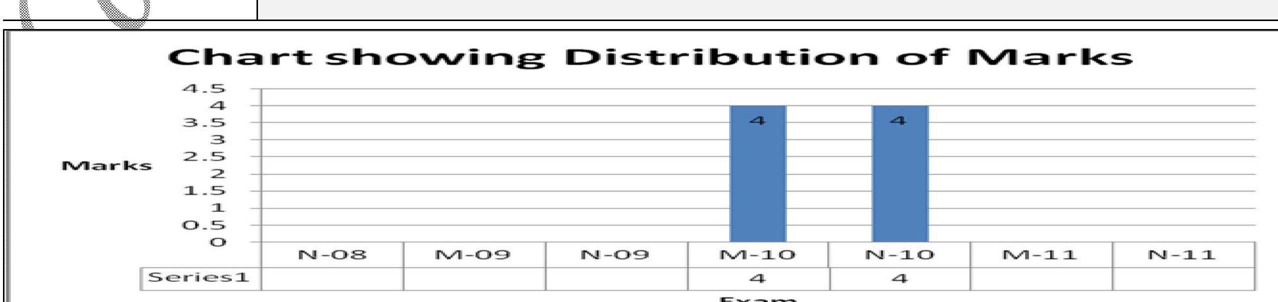
Meaning and Function of Cost Audit	Cost audit is the specific application of auditing principles and procedure in the field of cost accounting. Cost audit performs two basic functions: (i) Verification of cost accounting records such as accuracy of the cost accounts, cost reports, cost statements, cost data, costing techniques. (ii) Examination of cost accounting records to ensure that they adhere to the cost accounting principles, procedures and objectives. There is also a third function of cost audit which is to detect errors and to prevent frauds and possible misappropriations. This third function is, in fact, the function of all types of audit and not of cost audit alone.	
Types of Audit	***Cost audit on behalf of management***	The management's need for cost audit arise out of the following objectives a. Establishing accuracy of cost data. b. Ascertaining abnormal losses and gains along with their reasons; c. Establishing proper overhead rates for absorption of overheads; d. Fixation of contract price etc. e. Ensuring objective of cost accounting are being achieved. f. Determination of unit cost of production.
	Cost audit on behalf of customers	In case of cost plus contracts, often the buyer insists on a cost audit to satisfy himself about the accuracy of the assessed cost.
	Cost audit on behalf of government	Government may need the cost audit report for the following purposes: a. Considering the grant of subsidies to applicants; b. Assessment of tax leviable on production, etc.
	Cost audit by trade associations	Where the pricing of products in a particular trade are controlled by the concerned trade association, it may require cost audit report of its member units on the costing systems level of efficiency, utilization of capacity etc.
	Statutory Cost Audit	The Cost audit is also required under section 233B of the Companies Act, 1956.
ADVANTAGES OF COST AUDIT	***Management***	(a) The management will get reliable data for its day to day operations like price fixing, control, decision making etc. (b) A close and continuous check on all wastes will be kept through a proper system of reporting to the management. (c) Inefficiencies in the working of the company will be brought to the notice of the management to take corrective action. (d) Management by exception becomes possible through allocation of responsibilities to individual managers. (e) Facilitation of system of budgetary control and standard costing. (f) reliable check in the valuation of closing stock and WIP. (g) It helps in the detection of errors and fraud.
	Society	(a) Cost Audit is often introduced for the purpose of fixation of price. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation. (b) Price increase by the industry is not allowed without proper justification as to increase in cost of production. Consumers are saved from unreasonable price hike. (c) Cost Audit is also useful for the purpose of cost control, cot reduction and proper utilisation of scarce resources.

	Shareholder	• Cost audit ensures that proper records are kept as to purchases and utilisation of material and expenses incurred on wages, overheads etc. • It also ensures that the unit has been run economically and efficiently. • It also makes sure that the valuation of closing stocks and WIP is on a fair basis.
	Government	(a) Where the Government enters into a cost plus contracts, cost audit helps the Government to fix the price of the contract. (b) Cost Audit helps the fixation of selling prices of essential commodities and thus undue profiteering is checked. (c) Cost audit enables the Govt. to focus its attention on inefficient units. (d) Cost Audit enables the Government to decide in favour of giving protection to certain industries. (e) Cost audit facilitates the settlement of trade disputes brought to the government. (f) Since cost audit ensures efficient running of business and ensure accurate use of cost data, a healthy competition is generated among the various units and hence imposes an automatic check on inflation.
	Previous Years Questions ***Q. No. 1***: Write short note on: Advantages of cost audit to government. [Nov. 04 (4 marks)] ***Q. No. 2***: What are the advantages that accrue to the stockholders of a company because of a Cost audit? [May 07 (8 Marks)]	
FUNCTIONS OF COST AUDITOR	***Inventory***	The cost auditor will examine the following issues: (a) Is the size of the inventory adequate or in excess compared with the production programme? (b) Does it ensure optimum order size? (c) Does it take into account the storage cost as well as carrying cost? (d) Does it involve too many forms and too much paper? (e) Is there any scope for reduction of inventory cost consistent with production need? (f) Dose the issue of raw material make the production in accordance with the standard scheme or otherwise.
	Labour	The cost auditor must verify the followings: (a) Proper utilisation of labour; (b) Allocation of labour cost to different jobs with reference to time or job cards. (c) Steps taken to reduce the labour cost.
	Overheads and Indirect Expenditure	The cost auditor must verify the followings: (a) That allocation of indirect expenditure over production, sales, and distribution is logical and correct. (b) That compared with the value of production in a production shop, the overhead charges are not excessive. (c) That the actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for. (d) That the relation of indirect expenditure in keeping with the load on individual production shops is appropriate. (e) That allocation of overheads between finished products and unfinished products is in accordance with correct principles.

<table>
<tr><td rowspan="3"></td><td>Capacity Utilisation</td><td>The cost auditor will see:
(a) that the idle capacity of any production shop or of transport facilities for distribution is not excessive.
(b) That production volume and overall machine time utilized are commensurate. In other words, the machine hours utilized have given the optimum output.</td></tr>
<tr><td>Work in progress</td><td>The cost auditor will examine the followings issues:
(a) To ensure that WIP has been physically verified and also it agrees with the balance in the incomplete cost cards.
(b) That the valuation of WIP is correct with reference to the stage of completion of each job or process and the value in job cost cards or process cost sheets.
(c) That there is no over or under valuation of opening or closing WIP thereby artificially pushing up or down net profits or net assets as the case may be.
(d) That the volume and value of WIP is not disproportionate as compared to finished good production.</td></tr>
<tr><td>Store issue procedure</td><td>The cost auditor will see:
(a) That withdrawal of material from stores to production shop is scientific or covered by authorized schedule and permit receipts to be located;
(b) That there is no possibility of loss or pilferage of stock lying in the production sections;
(c) That surplus materials and scraps arising in production shops are returned to stores, correctly and without delay for which necessary credit is given to unit cost of production.</td></tr>
<tr><td rowspan="6">CIRCUMSTANCES UNDER WHICH A COST AUDIT IS ORDERED</td><td>Price Fixation</td><td>• specially in the case of materials of national importance like steel, cement etc.</td></tr>
<tr><td>Cost variation within the industry</td><td>• cost audit is essential for that industry where cost variations is significant from unit to unit to ascertain reasons for such variations.</td></tr>
<tr><td>Inefficient management</td><td>• cost audit helps to provide information to government about inefficient units for taking further necessary action.</td></tr>
<tr><td>Tax assessment</td><td>• cost audit determines correct cost of production so as to facilitate correct tax computation.</td></tr>
<tr><td>Trade Disputes</td><td>• cost audit is useful in setting trade disputes about the claim for higher wages, bonus etc.</td></tr>
<tr><td colspan="2">Previous Year Questions
Q. No. 3: State the circumstances that may warrant the introduction of Cost audit.
[June 09 – Old (6 Marks)]
Or
What is the purpose served by introduction of cost audit. [May 10 – New (4 marks)]</td></tr>
<tr><td>Matters to be included in Cost Audit Programme</td><td>Review of Cost accounting record</td><td>This will include:
• Method of costing in use
• Method of accounting for raw material, stores and spares, wastage
• System of recording wages, salary, etc.
• Basic of allocation of overheads to cost centres
• Treatment of expenses on finance, R&D, royalty, etc.
• Method for depreciation accounting
• Method of stocktaking and valuation
• System of budgetary control</td></tr>
</table>

<table>
<tr>
<td></td>
<td>Verification of cost statement and other data</td>
<td>This will mainly cover:
• Licensed, installed and utilized capacity
• Operating and financial ratio
• Production data
• Consumption of material and actual expenses
• Sales realization
• Abnormal non-recurring and special cost
• Reconciliation with financial books
Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.</td>
</tr>
<tr>
<td></td>
<td colspan="2">Previous Year Questions
Q. No. 4: Answer the following: “Like every other audit, a systematic planning for cost audit is also necessary”. Indicate the matters to be included in a Cost Audit Programme.
[Nov. 05 (10 Marks)]</td>
</tr>
<tr>
<td>STATUTORY COST AUDIT</td>
<td colspan="2">Cost Audit is basically carried out at the instance of the management for obvious advantages. However, Companies Act, 1956 provides for statutory cost audit. It is ordered by the Government form time to time under the provisions of Sec. 233B of Companies Act, 1956, whenever it feels that such type of audit necessary in case of a particular industry. For a cost audit, it is necessary that the company concerned should maintain cost records as required under the provisions of Sec. 209(1)(d) of the Companies Act.
Statutory cost audit can be conducted by a Cost Accountant or a Chartered accountant or any other person possessing the prescribed qualifications. The appointment of cost auditor should be made by the Board of Directors of the company with the previous approval of the Central Government.
The statutory cost audit was introduced keeping in view the following objectives:
(a) To make management cost conscious.
(b) To help in improving industrial efficiency all round and to maximise production.</td>
</tr>
<tr>
<td>TRUE AND FAIR COST OF PRODUCTION</td>
<td colspan="2">The concept of “True and Fair Cost of Production” is used in the context of cost audit wherein the cost auditor has to state whether in his opinion the company’s cost accounting records have been kept so as to give a true and fair view of the cost of production, processing and marketing of the product. A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking.
The following are the relevant considerations in determining whether the cost of production determined by the cost auditor is true and fair:
• Determination of cost following the generally accepted cost accounting principles
• Application of the costing system appropriate to the product
• Materiality
• Consistency in the application of costing system and cost accounting principles
• Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents
• Elimination of material prior-period adjustments
• Abnormal wastage’s and losses and other unusual transactions being ignored in determination of cost.</td>
</tr>
<tr>
<td></td>
<td colspan="2"><u>Previous Year Questions</u>
Q. No. 5: What is meant by True and Fair Cost of Production? [Nov. 02 (6 marks)]</td>
</tr>
</table>

Reconciliation of cost and financial accounts.	• A cost auditor is required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production etc. • Cost Auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power and scrap fuel cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, etc. • Annexure to the cost audit reports requires detailed information in respect of financial position including capital employed, net worth, gross profit, net profits, operating profit, unit cost of power and fuel, total wages and salaries etc. • It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. • Further the cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; • Under Part II of Schedule VI to the Companies Act, 1956, quite a few matters which are to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. • Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would required that the cost auditor may examine deviation before reporting on the same. • Thus it is imperative for the cost auditor to refer to financial records.
	Previous Years Question ***Q. No. 6:*** Write a short note on - Reconciliation of cost and financial accounts. [May 03, Nov. 10 - New (4 marks)]
Composite Audit	• Combining cost audit and financial audit to produce composite audit requirements would mainly depend upon whether objectives of cost audit and financial audit are common. • Objective of Financial Audit is to express an opinion on the true and fair information provided by the F.S. while the main objective of cost audit is to verify the cost statements and ascertain that cost of production is true and fair. • Cost audit can be considered as a tool of internal management by a company to operate effectively by disclosing weakness in cost accounting system and disclosing inefficiencies at all levels of organization. Financial audit on the other hand is conducted on behalf of shareholders and is directed to ascertain true and fair view of financial information. ***Conclusion***: It would be very difficult to reconcile the audit reports because the objectives of the two audits are all together different.
	Expected Question ***Q. No. 7***: It is not possible to merge cost audit with financial audit to have a composite audit. State with reasons whether the above statement is true or false.



Management Audit

Meaning	(a) Management audit is the audit of the management, i.e. evaluation of the mangers' ability to manage. (b) It may be defined as "the systematic independent appraisal activity, within an organization, for a review of the management's efficiency, in its decision making function. (c) It is concerned with appraising: • Management's accomplishment of organizational goals • Management functions of planning, organizing, directing and controlling. • Adequacy of management's decisions and action in attaining its objectives.	
Scope of Management Audit	**1. *Objectives***	Evaluation of functions of top management which • lay down objectives and policies, • provide means and procedures of implementation and control, and • actually engage in direction and control on a continuous basis.
	2. *Effectiveness*	Evaluation of relevance and effectiveness of the aims, duties and decisions of management at various levels.
	3. *Efficiency*	Review of efficiency in Mngt. decisions & functions and to judge whether (a) Management is doing the correct things (b) Management is doing those things correctly.
Need of Management Audit	1. For detecting and overcoming current problems 2. To assist the organization in accomplishing desired objectives. 3. Helpful for ailing industries. 4. For improved management in Public sector undertakings.	
Steps in Management Audit	***Stage I – Develop Mngt. Audit Program***	(i) <u>*Devising a statement of policy*</u>: in consultation with the top Management. The policy should ideally cover the scope, objective, the authority of the management audit function. (ii) <u>*Location of audit function within the organization*</u>: The hierarchical status of management auditor and his team should be clearly defined. (iii) <u>*Allocation of personnel*</u>: The management audit team should comprise of personnel who have adequate experience on various aspects of the organization. (iv) <u>*Staff Training*</u>: In order to maintain qualitative standards, adequate and continuous training should be offered to the management audit team. (v) <u>*Time and other aspects*</u>*:* Adequate consideration should be given to time & cost involved in conducting the audit. (vi) <u>*Frequency of audit*</u>: should be determined on the basis of changes in industry and in consultation with the top management.
	Stage II – Conduct of Audit	(1) Getting the facts through interviews (2) Measuring performance through Management Audit questionnaire.
	Stage III – Conclusion and reporting	(1) Pre Report Discussions (2) Preparing draft report (3) Supporting information (4) Writing & issuing the final report (5) Follow up of the report.
	Previous Year Questions ***Q. No. 1:*** K Ltd. requires you to organize a Management audit program. Briefly state a plan of action. [May 07 (8 Marks)]	

Management Audit Questionnaires	• A management audit questionnaire is an important tool for conducting the management audit. • Through these questionnaires auditors make an inquiry into important facts by measuring current performance.	
	Objective	• Comprehensive and Constructive examination of an organisation's management and its assigned tasks. • Appraisal of management actions in accomplishing the organisation's objectives. • Highlight weaknesses and deficiencies of the organisation. • Review of Mngt. functions of planning, organising, directing and controlling. • Evaluation of effectiveness of decision-making process in accomplishing the organisation objectives.
	Working	There are *three possible answers* to the management audit questions: "Yes", "No" and "N.A.". • "Yes" answer indicates that the specific area or function under study is functioning in an acceptable manner; no written explanation is needed in that case. • "No" answer indicates unacceptable performance and requires explained in writing. • Those questions that are not applicable and should be ignored in the audit are checked in the "N.A." column.
	Importance	It not only serves as a management tool to analyse the current situation; but also, it enables the management auditors to identify the elements that are causing organisational difficulties and deficiencies.
Management Audit Reports	***Oral Reports***	• Required in case of emergency. • But not considered reliable as no permanent record • Helps in taking corrective steps timely.
	Interim written report	• To inform management before regular report • Issued in case of matters requiring early consideration.
	Regular written reports	• Formal report submitted after completion of work.
	Summary written report	• Also known as "Flash' reports. • Summarizes various individual reports on integrated approach. • Facilitates management by exception.
Behavioural Aspects		
Causes	(1) Staff / Line conflict	• Management auditors are staff people while the members of other departments are line people. • Management auditors has superiority complex and they may think their approach and solutions are the only answers. • Staff do not consider the line before advising, as a result Line may not use advice of staff properly. • Line does not co-operate with staff and do not provide sufficient information to staff.

<table>
<tr><td></td><td>(2) Control</td><td>The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them.
There is a fear that the action taken based on the management audit report will affect the line people. The causes are as under:
(i) Fear of criticism as a result of adverse audit findings.
(ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.
(iii) Punitive action by superior prompted by reported deficiencies.
(iv) Hostile audit style.</td></tr>
<tr><td>Solution to behavioral problems</td><td colspan="2">(i) Demonstrate that audit is part of an overall programme of review for protective and constructive benefit.
(ii) Demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.
(iii) Perform the review to ensure minimum interference with regular operation.
(iv) Involve responsible officers in the process of review of the findings and recommendations before the audit report is formally released.
(v) Create an atmosphere of trust and friendliness.</td></tr>
<tr><td></td><td colspan="2"><u>Previous Year Questions</u>
Q. No. 2: Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. [May 04 (8 Marks)]</td></tr>
</table>

OPERATIONAL AUDIT

<table>
<tr><td>Meaning</td><td colspan="2">• Operational Audit is the review and appraisal of operations of an organization conducted by competent independent person.
• It analyse the regular operations like production, purchase, sales etc. to check whether they are in tune with company’s policies, objectives and goals or not.
• It focuses more on Qualitative aspects of operations rather than regular accounting aspects.</td></tr>
<tr><td rowspan="4">Objectives of Operational Audit</td><td>1. Appraisal of Controls</td><td>Operational auditing deals with the administrative controls and its purpose is to determine whether the controls are adequate.</td></tr>
<tr><td>2. Evaluation of performance</td><td>• In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards.
• The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise.</td></tr>
<tr><td>3. Appraisal of objectives and plans</td><td>In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the <u>effectiveness, efficiency and economy</u> with which the operations are being carried on.</td></tr>
<tr><td>4. Appraisal of organisational structure</td><td>In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority.</td></tr>
<tr><td></td><td colspan="2">Previous Year Questions
Q. No. 3: Briefly explain the objectives of Operational Audit. [Nov. 06 (5 Marks)]</td></tr>
</table>

Operational Auditing Vs Internal Auditing

Operational Auditing	*Internal Auditing*
It is concerned with the review and appraisal of operations of an organization carried on by a competent independent person	It is concerned with determining whether other internal controls are well designed and in place
It is not a part of internal control	It is a part of internal control system
It is an constructive function i.e. to provide suggestions for improvement	It is an protective function i.e to safeguard the assets of the enterprise.
It analyses all aspects of operations whether they are in tune with management policies, objectives and Goals	It is primarily concerned with financial accounting and internal control
It mainly deals with qualitative aspects	It focuses more on quantitative aspects

Financial Auditing Vs. Operational Auditing

	Financial Auditing	*Operational Auditing*
Purpose	It concerned with the opinion that whether the historical information recorded is correct or not	It emphasizes on effectiveness and efficiency of operations for future performance.
Area	It is restricted to the matters directly affecting the appropriateness of the presented financial statements	It covers all the activities that are related to efficiency and effectiveness of business operations.
Reporting	Financial audit report is sent to all stock holders, bankers and other persons having interest in the organization.	Operational audit report is primarily for the management
End Task	Financial audit reports the findings to the persons as its end objectives.	Operational audit is not limited to the reporting only, but includes suggestions for improvements also.

Previous Years Questions

Q. No. 6: What are the major differences between Financial and Operational Auditing? [May 08 (8 Marks)]

Miscellaneous Topics

Factors Causing Unsatisfactory Production

(i) Non-availability of raw materials
(ii) Inadequate or unskilled personnel
(iii) Lack of proper supervision
(iv) Lack of proper machine maintenance
(v) Strikes and/or lock out
(vi) Problems of power supply
(vii) Non-availability of essential machine spares
(viii) Lack of proper quality control
(ix) Poor quality of raw materials
(x) Other causes like fire, earthquake etc

Previous Years Questions

Q. No. 7: In an operational audit performance evaluation, what factors can cause unsatisfactory production performance? [June 09 – Old (4 Marks)]

<table>
<tr><td rowspan="4">Participative Approach</td><td>Need</td><td>

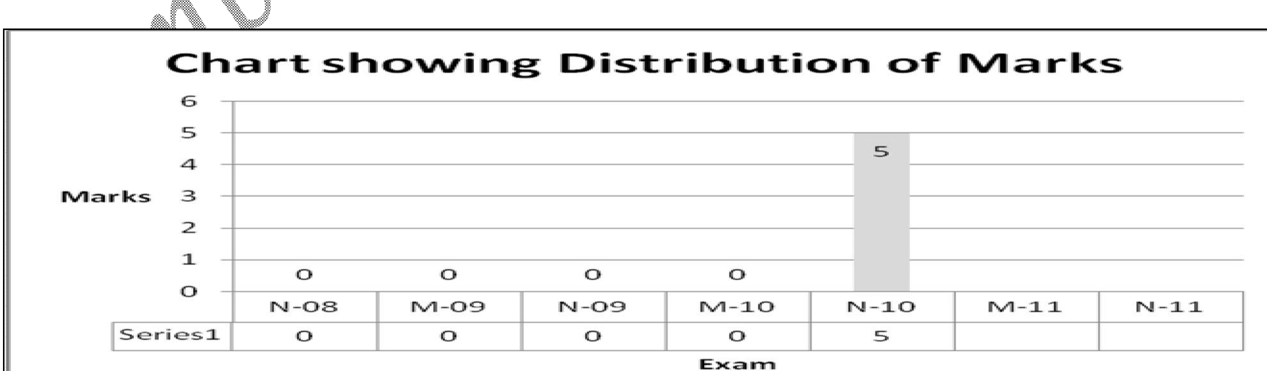
While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.
These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers.
This would defeat the very purpose of the operational audit.
The Participative Approach comes to the help of the auditor.
</td></tr>
<tr><td>How it works</td><td>

In this approach the auditor discuses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements.
This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion.
The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report.
With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.
</td></tr>
<tr><td>Benefits</td><td>

Resistance to change becomes minimal,
Feelings of hostility disappear
feelings of mutual trust develops.
Development of Team spirit.
</td></tr>
<tr><td colspan="2">Previous Years Questions
Q. No. 8: XYZ, a manufacturing unit does not accept the recommendation for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management. [Nov. 10 – New (5 Marks)]</td></tr>
<tr><td>Use of Quantitative Ratios</td><td colspan="2">

The objective of management-cum-operational audit is not only to verify compliance with the control but to suggest measures to improve operational environment & increase overall productivity.
Financial ratios keep changing with the variations in the price level. In a dynamic economy, price levels seldom remain constant and hence comparison of financial ratios over the years becomes vitiated. Quantitative ratios and reconciliations remain unaffected by changes in price. They reflect certain basic relationships and change only if there is a change in the method of operation, technology, degree of automation, product mix, etc.
A comparison of quantitative ratios over the years can reveal pertinent and leading indications of the real state of affairs.
The various quantitative ratios which may be calculated are input-output ratio for a manufacturing concern, occupancy ratio for hotels, etc.
The nature of quantitative ratios and reconciliations that an auditor can work out in a particular audit would depend upon the actual circumstances of the case. However, the auditor must keep a few general considerations in mind while using quantitative data.
Firstly, he should analyse and use such data mainly as an evidence to support the figures in the statements under audit.
</td></tr>
</table>

	• Secondly, the auditor should try to correlate vital relationships between physical quantities. In this regard the auditor should establish the cause and effect relationship between activities. • Thirdly, the auditor may attempt to link a physical quantity with its corresponding monetary figure through an estimated average rate. ***Conclusion***: Though working out quantitative ratios involves greater strain on the auditor, but it is more rewarding.	
	Expected Question ***Q. No. 8***: You have been appointed to carry out Management-cum-Operational Audit of a Public Ltd company. State whether the use of quantitative ratios is more effective than the use of financial ratios to gain real insight into the financial statements. (8 Marks)	
Action Plan for management audit of a company facing financial crunch	***Working Capital Estimation***	• Prepare a statement of the projected working capital requirements. • It should be based on the functional budgets in sales, production, expenses, capital expenditure and the master budget consisting of projected profit and loss and the balance sheet.
	Cash Flow Statement / Cash Budget	• Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity.
	Inventory/Stock Management	• Raw materials and inventories should be classified properly to determine the level of stock of materials. • The system of inventory management needs to be looked at so as to check the avoidable wastes/scraps generated during storage and handling.
	Credit Management	• The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. • An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. • The sale department needs to be geared up so that realisation can be made in time.
	Funds Flow Analysis	• The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.
	Investment Management	• The idle funds of the company, if any, should be invested in short-term securities to augment the income
	WIP Analysis	• WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.
	Expected Question ***Q. No. 9***: You have been appointed Management Auditor of a large manufacturing company suffering from working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem.	



Chapter - 4 TAX AUDIT & VAT AUDIT

AUDIT REQUIREMENT UNDER INCOME TAX ACT, 1961

Audit of Trust registered u/s 12A

An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

(i) Check the books of account and other records having regard to the system of accounting and internal control

(ii) Vouch the transactions of the trust to satisfy that:

- (a) the transaction falls within the ambit of the trust
- (b) the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;
- (c) all incomes due to the trust have been properly accounted for on the basis of the system of accounting followed by the trust;
- (d) all expenses and outgoings appertaining to the trust have been recorded on the basis of the system of accounting followed by the trust;
- (e) amounts shown as applied towards the object of the trust are covered by the objects of trust as specified in the document governing the trust.

(iii) Obtain trial balance on the closing date duly certified by the trustees.

(iv) Obtain Balance Sheet and Profit & Loss Account of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Previous Years Questions

Q. No. 1: Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961. [May 09 – New (8 Marks)]

TAX AUDIT U/S 44 AB

Applicability	Sec 44AB is applicable to the following classes of assesses: (a) Assessee carrying on business where total sales or turnover or gross receipts exceeds Rs. 60 lakhs. (b) Assessee carrying on profession where Gross Receipts exceeds Rs. 15 Lakhs or (c) Assessee carrying on the business referred to u/s 44AD/44AE/44AF/44BB (Exploration of Mineral Oil) /44BBB (Foreign companies engaged in Civil Construction) and declaring lower income than prescribed under those sections. ***Note: Where the assessee is proprietor of more than one concern, aggregate of all the businesses to be taken into consideration for the purposes of compliance with the provisions of sec. 44AB.***
Liability for Tax Audit	• There is no liability of tax audit if the assessee is not covered u/s 44AB. • A charitable trust, cooperative society etc., though their income may be exempt, even if turnover exceed the threshold limit, they should get their account audited. • If income of an assessee is ***below the taxable limit***, he will also liable to get his account audited, if the turnover in business exceed the threshold limit. • Section 44AB not applicable to assessee covered us 44B (Shipping Business) and 44BBA (Operation of Aircraft). • Section 44AB is applicable to NRI also.

	Auditor	• The audit shall be conducted by a C.A. as explained u/s 288 of the I. T. Act, 1961. • Proviso to Sec. 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person get the accounts of such organisation audited under such other law before the specified date and furnishes by that date, the report of the audit as required under such other law and a further report by an Accountant in the form prescribed under this section. • In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a C.A., the statutory auditor need not be a C.A.
	Specified date for filing of Report	30^{th} Sep. of relevant AY.
	Forms of report	• The audit u/s 44AB requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in Form 3CD. • The auditor has to examine whether the information given is true and correct. The Form 3CD is not a report of Tax Auditor. • The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. • If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in Form 3CA or 3CB saying "in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3CD are true and correct." ***<u>Forms requirement</u>***: (i) Form 3CA and 3CD for person carrying on Business or profession who is required under any other law to get his accounts audited; and (ii) Form 3CB and 3CD for others.
	Methods of Accounting & Accounting Standards (Sec. 145)	
	Sec. 145 (1)	Income chargeable under the head '*PGBP* or '*Other sources*' shall, be computed in accordance with either ***<u>cash or mercantile system of accounting</u>*** regularly employed by the assessee.
	Sec. 145 (2)	The C.G. may notify in the Official Gazette from time to time ***AS*** to be followed by any class of assessees or in respect of any class of income.
	Sec. 145(3)	Where the A.O. is not satisfied about the correctness or completeness of the accounts of the assessee, or where method of accounting provided u/s 145(1) or AS as notified u/s 145(2) have not been regularly followed by the assessee, the A.O. may make an assessment in a manner provided in Sec. 144 of the Income Tax Act.
		The Central Government has prescribed the following AS: AS I Disclosure of accounting policies. AS II Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies.

		The above ASs are to be followed by all assessee following ***mercantile system*** of accounting. Therefore, it is clear that those assessees who are following cash system of accounting need not follow the ASs notified above.
	Auditor's Duties	To ensure compliance of section 145, the auditor has to ensure the following: • the entity follows either the Cash or Accrual method of Accounting. • Accounting Policies as required by AS (IT) -1 has been disclosed separately. • Other provisions of AS 1 (IT) and AS (IT) -2 have been complied with.

Previous Years Questions

Q. No. 2: As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the Income Tax Act, 1961?

[May 09 – New (8 Marks)]

Q. No. 3: Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law.

[Nov. 09 – New (4 Marks)]

Q. No. 4: A Co-operative Society having receipts above Rs. 60 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a C.A. State with reasons whether such audit report can be furnished as tax audit report u/s 44AB of the Income Tax Act, 1961? [Nov. 09 – New (3 Marks)]

Answer: Proviso to Sec. 44AB lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person get the accounts of such organisation audited under such other law before the specified date and furnishes by that date, the report of the audit as required under such other law and a further report by an Accountant in the form prescribed under this section.

In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a C.A., the statutory auditor need not be a C.A.

Thus, it shall be sufficient compliance with the provisions of this section and can be considered under section 44AB.

FORM NO. 3CD

Statement of Particulars required to be furnished under section 44AB of the Income Tax Act,1961

PART - A

1	Name of the Assessee	
2	Address	
3	Permanent Account Number	
4	Status	
5	Previous year ended	31ST MARCH, 20XX
6	Assessment year	20XX-20XX

PART - B

7	(a)	If *firm or Association of Persons*, indicate names of partners /members and their profit sharing ratios.
	(b)	If there is any change in the partners / members or their sharing ratios, the particulars of such change.
8	(a)	Nature of business or profession.
	(b)	If there is any change in the nature of business or profession, the particulars of such change.

9	***(a)***	***Whether books of accounts are prescribed under section 44AA, if yes, list of books so prescribed.***	
	(b)	***Books of account maintained*** ***(In case Books of Accounts are maintained in a computer system, mention the books of accounts generated by such computer system)***	
	(c)	***List of books of account examined.***	
10		Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant section (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB or any other relevant section).	
11	***(a)***	***Method of accounting employed in the previous year.***	
	(b)	***Whether there has been any change in the method of accounting employed vis-à-vis the method employed in the immediately preceding previous year.***	
	(c)	***If answer to (b) above is In the affirmative, give details of such change, and the effect thereof on the profit or loss.***	
	(d)	***Details of deviation, if any, in the method of accounting employed in the previous year form the accounting standards prescribed under section 145 and the effect thereof on the profit or loss.***	
12	***(a)***	***Method of valuation of closing stock employed in the previous year.***	
	(b)	***Details of deviation, if any, from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss.***	
12A.		Give the following particulars of the capital asset converted into stock-in-trade: -	
	(a)	Description of capital asset;	
	(b)	Date of acquisition;	
	(c)	Cost of acquisition;	
	(d)	Amount at which the asset is converted into stock-in trade.	
13		Amounts not credited to the profit and loss account, being, -	
	(a)	the items falling within the scope of section 28;	
	(b)	the proforma credits, drawbacks, refunds of duty of customs or excise or service tax, or refunds of sales tax or VAT, where such credits, drawbacks or refunds are admitted as due by the authorities concerned;	
	(c)	escalation claims accepted during the previous year;	
	(d)	any other item of income;	
	(e)	capital receipt, if any.	
14		Particulars of depreciation allowable as per the Income Tax Act,1961 in respect of each asset or block of assets, as the case may be, in the following form:	
	(a)	Description of asset/block of assets.	
	(b)	Rate of depreciation.	
	(c)	Actual cost or written down value, as the case may be.	
	(d)	Addition/deductions during the years with dates, in the case of any addition of an asset, date put to use; including adjustments on account of -	
		(i)	Modified VAT credit claimed and allowed under the Central Excise Rules,1944 in respect of assets acquired on or after 1st March,1994,
		(ii)	change in the rate of exchange of currency, and
		(iii)	subsidy or grant or reimbursement, by whatever name called
	(e)	Depreciation allowable	
	(f)	Written down value at the end of the year.	

15		Amount admissible under section-	
	(a)	33AB	
	(b)	33ABA	
	(c)	33AC(wherever applicable)	
	(d)	35	
	(e)	35ABB	
	(f)	35AC	
	(g)	35CCA	
	(h)	35CCB	
	(i)	35D	
	(j)	35DD	
	(k)	35DDA	
	(l)	35E	
	(a)	debited to the profit and loss account (showing the amount debited and deduction allowable under each section separately).	
	(b)	Not debited to profit and loss account.	
16	(a)	Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [section 36(1)(ii)]	
	(b)	Any sum received from the employees towards contributions to any PF or superannuation fund or any other fund mentioned in section 2(24)(x); and due date for payment and the actual date of payment to the concerned authorities under section 36(1)(va).	
17	Amount debited to the profit and loss account, being:-		
	(a)	expenditure of capital nature;	
	(b)	expenditure of personal nature;	
	(c)	expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party;	
	(d)	***expenditure incurred at club-***	
		(i)	***as entrance fees and subscriptions;***
		(ii)	***as cost for club services and facilities used;***
	(e)	(i)	expenditure by way of penalty or fine for violation of any law for the time being in force;
		(ii)	any other penalty or fine;
		(iii)	expenditure incurred for any purpose which is an offence or which is prohibited by law;
	(f)	amounts inadmissible under section 40(a);	
	(g)	interest, salary, bonus, commission or remuneration inadmissible under section 40(b) / 40 (ba) and computation thereof;	
	(h)	***(A)***	***whether a certificate has been obtained from the assessee regarding payments relating to any expenditure covered under section 40A(3) that the payments were made by account payee cheques drawn on a bank or account payee bank draft, as the case may be;***
		(B)	***amount inadmissible under section 40A(3), read with rule 6DD [with break-up of inadmissible amounts;***
	(i)	provision for Payment of Gratuity not allowable under section 40A(7);	
	(j)	any sum paid by the assessee as an employer not allowable under section 40A(9);	
	(k)	particulars of any liability of a contingent nature.	
	(l)	amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of total income.	
	(m)	amount inadmissible under the proviso to section 36(1)(iii);	

17A				Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006
18				***Particulars of any payment made to persons specified under section 40A(2)(b).***
19				Amounts deemed to be profits and gains under section 33AB or 33AC or 33ABA.
20				Any amounts of profits chargeable to tax u/s 41 and computation thereof
21	(i)			In respect of any sum referred to in clause (a),(c),(d),(e) or (f) of section 43B the liability for which:
		(A)		pre-existed on the first day of the PY but was not allowed in the assessment of any preceding PY and was
			(a)	paid during the previous year;
			(b)	not paid during the previous year;
		(B)		was incurred in the previous year and was
			(a)	paid on or before the due date for furnishing the return of income of the previous year 139(1);
			(b)	not paid on or before the aforesaid date.
22	(a)			Amount of MODVAT Tax Credits availed of or utilised during the PY and its treatment in P & L A/c and treatment of outstanding MODVAT Tax Credits in accounts.
	(b)			Particulars of income or expenditure of prior period credited or debited to the profit and loss account.
23				Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque. (Section 69D)
24	(a)			* particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year :
		i)		Name, Address and Permanent Account Number (if available with the assessee) of the lender or depositor;
		ii)		Amount of loan of deposit taken or accepted;
		iii)		Whether the loan or deposit was squared up during the PY;
		iv)		Maximum amount outstanding in the account at any time during the PY;
		v)		Whether the loan or deposit was taken or accepted otherwise than by an A/c payee Bank cheque or A/c payee bank draft
				*(These particulars need not be given in case of a Government Company, a banking company or a corporation established by a Central, State or Provincial Act)
	(b)			Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year :-
		i)		Name, Address and Permanent account number (if available with the assessee) of the payee;
		ii)		Amount of the repayment;
		iii)		Maximum amount outstanding in the account at any time during the previous year;
		iv)		Whether the repayment was made otherwise than by account payee cheque or account payee bank draft.
25				***Details of brought forward loss or depreciation allowance, in the following manner, to the extent available :***
	(a)			(see table below)

Serial No.	***Assessment Year***	***Nature of Loss /Allowance (in Rs.)***	***Amount as returned (in Rs.)***	***Amount as Assessed (in Rs.)***	***Remarks***

25	(b)	Whether a change in shareholding of the company has taken place in the PY due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79

26				Section-wise details of deductions, if any admissible under Chapter VIA.
27	***(a)***			***Whether the assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government.***
	(b)			***If the provisions of Chapter XVII-B have not been complied with, please give the following details*, namely:-***
		(i)		***Tax deductible and not deducted at all***
		(ii)		***Shortfall on account of lesser deduction than required to be deducted***
		(iii)		***Tax deducted late***
		(iv)		***Tax Deducted but not paid to the credit of C.G.***
28	(a)			In the case of a trading concern, give quantitative details of Principal items of goods traded;
		i)		opening stock;
		ii)		purchases during the previous year;
		iii)		sales during the previous year;
		iv)		closing stock;
		v)		shortage/excess, if any.
	(b)			In the case of manufacturing concern, give quntitative details of the pinicipal items of raw materials, finished products any by-products.
		(A)		Raw materials;
			i)	opening Stock;
			ii)	purchases during the previous year;
			iii)	consumption during the previous year;
			iv)	sales during the previous year;
			v)	closing stock;
			vi)	* yield of finished products;
			vii)	* percentage of yield;
			viii)	* shortage/excess, if any;
		(B)		Finished products / By products :
			i)	opening stock;
			ii)	purchases during the previous year;
			iii)	quantity manufactured during the previous year;
			iv)	sales during the previous year;
			v)	closing stock;
			vi)	shortage/excess, if any.
				* Information may be given to the extent available.
29	***In the case of Domestic Company, details of tax on distributed profits u/s 115-O in the following form:***			
	(a)			***total amount of distributed profits;***
	(b)			***total tax paid thereon;***
	(c)			***dates of payment with amounts.***
30	Whether any cost audit was carried out, if yes, enclose a copy of report of such audit [See Section 139(9)].			
31	Whether any audit was conducted under the Central Excise Act, 1944, if yes, enclose a copy of the report of such audit.			

32	***Accounting ratios with calculations as follows :***	
	(a)	***Gross profit/Turnover;***
	(b)	***Net profit/Turnover;***
	(c)	***Stock-in-Trade/Turnover;***
	(d)	***Material consumed/Finished goods produced.***

FOR XYZ ASSOCIATES
CHARTERED ACCOUNTANTS

PLACE :
DATED :

Previous Years Questions

Q. No. 5: Write a short note on - Method of Accounting in Form No. 3CD of Tax Audit. [May 07 (4 Marks)]

Q. No. 6: Write a short note on - Accounting ratios in Form 3 CD of Tax Audit. [Nov. 07 (4 Marks)]

Answer: Accounting Ratios in Form 3CD of Tax Audit

(a) Gross Profit/Turnover.
(b) Net Profit/Turnover.
(c) Stock in Trade/Turnover.
(d) Material consumed/finished goods produced.

These ratios have to be calculated only for assessees who are engaged in ***manufacturing or trading activities***. This clause is ***not applicable to assessees carrying on profession***. Moreover, the ratios have to be given for the ***business as a whole*** and need ***not be given product wise***. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

Q. No. 7: Answer the following: As the tax auditor of a Company, how would you report on payments exceeding Rs. 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year? [May 08 (5 Marks)]

Answer: ***Reporting of payments exceeding Rs. 20,000 in cash***: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD. The tax auditor shall have to report for clause 17(h) for the above as per the amended section 40A (3) of the Income Tax Act, 1961.

In the instant case the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding Rs. 20,000, the reporting thereof would be necessary in clause 17(h) of Form 3CD. The sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6 DD along with computation.

The entire amount paid as above, is likely to be disallowed u/s 40A(3) of the Income Tax Act, 1961.

Q. No. 8: State whether a Tax audit report can be revised and if so state those circumstances. [Nov. 08 – New (4 marks)]

Answer: Revision of Tax audit Report:

Normally, the report of the tax auditor cannot be revised later. However, when the accounts are revised in the following circumstances, the tax Auditor may have to revise his Tax audit report also.

(i) Revision of accounts of a company after it adoption in the annual general meeting.
(ii) Change in law with retrospective effect.
(iii) Change in interpretation of law (e.g.) CBDT Circular, Notifications, Judgments, etc.

The Tax Auditor should state it is a revised Report, clearly specifying the reasons for such revision with a reference to the earlier report.

Q. No. 9: Discuss the reporting requirement in Form 3CD of Tax Audit Report under Section 44AB of the Income-tax Act, 1961 for the following:

(a) Tax Deducted at Source

(b) Expenditure incurred at the club. [Nov. 08 – Old (8 Marks)]

Answer: Refer Clause 27 and 17(d).

Q. No. 10: State the reporting requirement regarding books of account (prescribed, maintained and examined) in Form No. 3CD of Tax Audit under Section 44AB of the Income Tax Act, 1961. [May 09 – Old (8 Marks)]

Answer: Refer Clause 9.

Q. No. 11: ABC Printing Press, a proprietary concern, made a turnover of above Rs. 43 lacs for the year ended 31.03.2009. The Management explained its auditor Mr. Z, that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.

[Nov. 09 – New (5 Marks)]

Answer: The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately.

The use of different papers (quality, quantity and size) ink, colour etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom.

At the same time, he has to report and certify under the Para 28(b) and Para 9(b) of Form 3CD read with the Rule 6G(2) of the Income Tax Act, 1961, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.

Q. No. 12: Discuss the reporting requirements in Form 3CD of the Tax Audit Report U/S 44AB of the Income-tax Act, 1961 for the following:

(i) Tax on distributed profits. [Nov. 09 – Old (4 Marks)]

(ii) Brought forward loss or depreciation allowance. [Nov. 09 – Old (4 Marks)]

Answer: Refer Clause 29 and 25.

Q. No. 13: Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40 A (3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment. [Nov. 10– New (5 Marks)]

Answer: Under clause 17(h) of Form 3CD, amounts inadmissible under section 40A(3), read with Rule 6DD, have to be reported. Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD. Mr. R has to report the payments inadmissible under section 40A (3) under clause 17(h) of Form 3CD.

AUDIT UNDER STATE VAT LAW

Concept of VAT	• VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. • VAT is an indirect Tax on consumption. • The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.	
Steps taken by auditor	1. ***Knowledge of Business***	The Auditor should familiarize himself with the business of the Auditee.
	2. ***Knowledge about VAT Law and Allied Laws***	The Auditor should study the VAT Law particularly • definitions, • procedures to be adopted, • provision regarding issues of invoices, • claiming of input tax credit etc.
	3. ***Major Accounting Policies***	The Auditor should ascertainable major accounting policies with regard to • sales, • purchases and • valuation of inventory
	4. ***Accounting Records maintained by Auditee***	The auditor should obtain a complete list of all the accounting records relating to • Sales / purchase of goods, • stock, • various registers, ledgers in which, the transactions are recorded.
	5. ***Evaluation of Internal control***	The Auditor should evaluate the internal controls prevalent in the entity with respect to • sales, • Purchases, • Production and • Accounting. He must examine the adequacy and effectiveness of the controls in order to plan the nature and timing of his audit procedures.
Previous Exam Questions	***Q. No. 14***: Write short note on: Major Steps required in the Preparation of tax audit under VAT Law. [May 10 – New (5 Marks)]	

Audit under Excise Law – EXCISE AUDIT 2000

Audit Procedure	1. ***Selection of Assessee***	Units are selected based on risk factors like • record of duty evasion, • major audit objection etc.
	2. ***Desk Review***	In this stage, the auditors are required to gather as much information about the assessee as possible. Information may be gathered from • departmental records, • published statements like annual reports and • other market enquiries. Since this can be done without interacting with the assessee, it is called desk review
	3. ***Documenting information***	In this stage, the auditor obtains the required information from the assessee.

	4. Touring	The auditor visits the business unit to see • the actual running, • the system for maintenance of records and • movement of the goods.
	5. Audit Plan	• On the basis of the information gathered by him the auditor should formulate his audit plan. • The plan should identify areas vulnerable from the revenue point of view.
	6. Verification	After formulation of the audit plan the auditor should conduct the actual verification of the records and document.
	7. Audit objection and Audit Para	• After completion of verification of records, if the auditor has observed any short payment of duty or non-observance of central Excise Procedures, he should discuss the same with the assessee. • On the basis of the explanations received if the auditor is satisfied that there has been non compliance of procedures, results in loss of revenue, he should record the same as 'Audit Objection' or 'Audit Para' of the 'draft audit report'.
	8. Audit Report	• All the audit objections / audit paras are compiled to prepare the 'Draft Audit Report'. • This report is submitted to the reviewing officer who finalizes the same.

Areas of concern in an audit of indirect taxes

(i) Non availment or short / excess availment of control or export incentives.

(ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.

(iii) Valuation Issues – valuation not in line with rules.

(iv) Applicability of the relevant control excise exemptions.

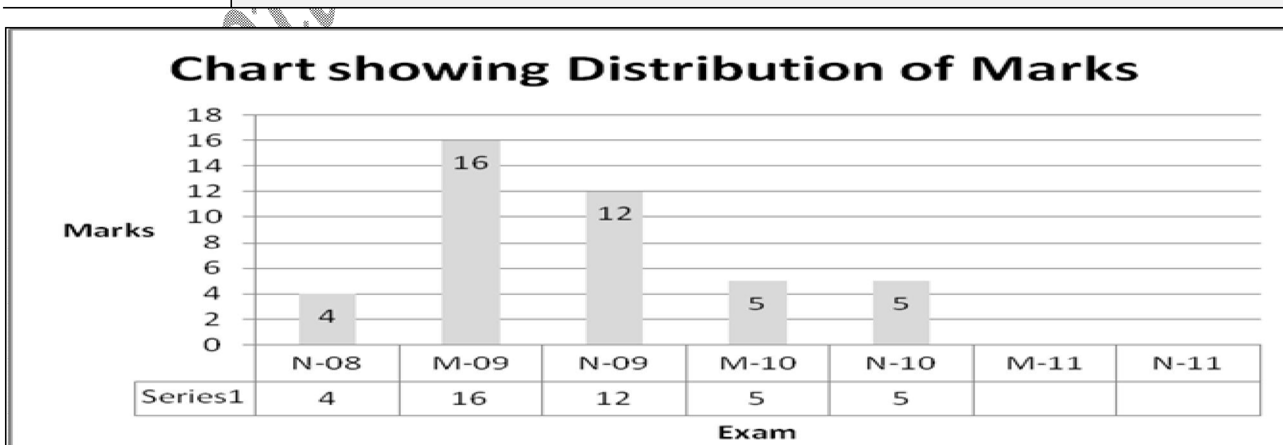
(v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.

(vi) Ignoring Liability under Service Tax on services provided or availed.

(vii) Procedural non-compliance.

(viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

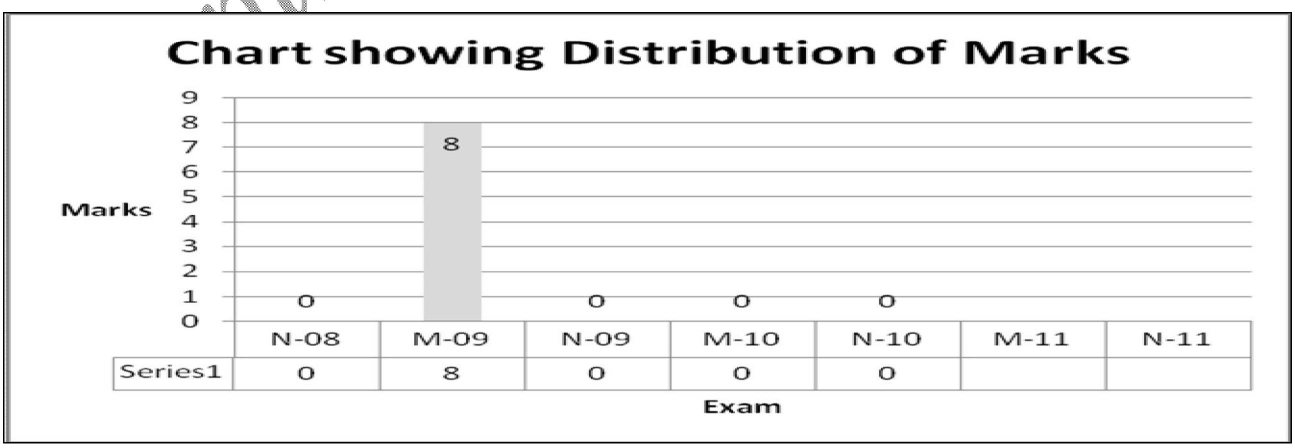
Previous Exam Questions	***Q. No. 15***: Enumerate some of the areas of concern in an audit of indirect taxes. [Nov. 05 (6 Marks)]



Chapter – 5 Audit of Consolidated Financial Statements

Meaning and contents of Consolidated Financial Statements (CFS)	• CFS are presented for a ***Group*** of entities under the ***control of a Parent***. • A parent is an entity that has one or more subsidiaries. • A group comprises a parent and its subsidiaries. • Thus, consolidated Financial Statements are the financial statements of a group presented as those of a single entity. • CFS is presented, to the extent possible, in the same format as adopted by the parent for its separate Financial Statements. • AS - 21 lays down principles and procedures for preparation and presentation of CFS.
	It normally includes • Consolidated balance Sheet, • Consolidated Statement of Profit & Loss and • Notes, Explanatory material that form an integral part thereof and • Consolidated Cash Flow Statement (in case a parent presents its own Cash Flow Statement).
Responsibility of the auditor of the CFS	The auditor of the CFS is responsible for expressing an opinion on whether the CFS are prepared, in all material respects, in accordance with the FRF under which the parent prepares the CFS. Therefore, the auditor's objectives in an audit of CFS are: (a) to satisfy himself that the CFS have been prepared in accordance with the requirements of AS – 21 "Consolidated Financial Statements" AS-23 "Accounting for Investments in Associates in Consolidated Financial Statements" and AS-27 "Financial Reporting of Interests in Joint Ventures"; and (b) To enable himself to express an opinion on the' true and fair view presented by the CFS.
Planning the audit of CFS	Before commencing an audit of CFS, the auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. The auditor should make plans, among other things, for the following: (a) understanding of accounting policies of the parent, subsidiaries, associates and joint ventures; (b) determining the extent of use of other auditors work in the audit; (c) determining & programming the N, T, E of the audit procedures to be performed; and (d) coordinating the work to be performed.
General Considerations in Auditing the CFS	(a) The auditor should obtain a list of subsidiaries, associates & joint ventures included in CFS. (b) The auditor should review the information provided by the management of the parent identifying the subsidiaries, associates and joint ventures. (c) The auditor should verify that all the subsidiaries, associates and joint venture have been included in the consolidated financial statements. (d) In respect of completeness of this information, the auditor should perform the following procedures: • review his working papers for the prior years for the known subsidiaries, associates and joint ventures; • review the parent's procedures for identification of subsidiaries and joint ventures; • review the investments to determine the shareholding in other entities; • review the joint venture and other relevant agreements entered into by the parent; • review the statutory' records maintained by the parent, for example registers under section 302,372A of the Companies Act, 1956. (e) The auditor should also identify the changes in the shareholding that might have taken place since the last audit. (f) The auditor should verify that the adjustments required by the relevant AS have been made wherever required and have been properly authorized by the Mngt. of the parent. The preparation of CFS gives rise to Permanent Consolidation Adjustments and Current Period Consolidation Adjustments.

SPECIAL CONSIDERATIONS	***Current Period Consolidation Adjustment***	These are those adjustments made in the accounting period for which CFS statements are prepared. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including: (a) intra-group interest paid and received or management fees, etc; (b) unrealised intra-group profits on assets acquired from other subsidiaries; (c) intra-group indebtedness; (d) adjustments relating to harmonising the different accounting policies being followed by the parent enterprise and its subsidiaries; (e) adjustments made for effects of significant transactions or other events that occur between the date of the financial statements of the parent and one or more of the components, if the financial statements to be used for consolidation are not drawn upto the same reporting date; and (f) determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.
	Permanent Consolidation Adjustments	Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. These adjustments are: (i) Determination of excess or deficit of the cost to the parent of its investments in subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made. (ii) Determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made; and (iii) Determination of Goodwill or capital reserve arising on application of equity method to account for investment in associates in consolidated financial statements.
	Previous Years Questions ***Q. No. 1***: Write short note on: Permanent Consolidation adjustments. [Nov. 08 – Old (4 Marks)] ***Q. No. 2***: While doing the audit of consolidated Financial Statements, which current period consolidation adjustments are to be taken into account? [June 09– New (8 Marks)] or Write short notes on: Current Period Consolidation Adjustments. [Nov. 09 – Old (4 Marks)]	



Audit v/s Investigation

Auditing	It involves *examination* of *financial information* contained in financial statements to *express an opinion* whether or not the same have been prepared properly. In essence, auditing involves independent examination of financial information prepared by the management of an entity.
Investigation	• It implies *systematic, critical and special examination* of the records of a business for a *specific purpose*. • The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. • Investigation requires a concentrated focus on the subject matter of inquiry and related matters.
Auditing vs. Investigation	Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. (a) Auditing is general while investigation is specific. (b) The object of auditing is to ensure that the financial statements are True and fair and not misleading or unreliable. Investigation may be in connection with a suspected fraud. (c) Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor. Investigation is carried out generally in those areas where suspicion arouses ***Previous Years Questions*** ***Q. No. 1***: Write a short note on - Audit and Investigation. [Nov. 04 (4 marks)]
Steps in Investigation	(1) Determination of ***objective*** and establishment of ***scope*** of investigation. (2) Formulation of ***Investigation programme***. (3) ***Examination and study*** of various records and collect appropriate evidences. (4) ***Analysis, processing and interpretation*** of findings. (5) Draw up a ***conclusion*** and prepare the investigation ***report***.

Types of investigations	***Statutory***	As an inspector under Sections 235 to 251 of the Companies Act, 1956.
	Non-statutory	• Investigation on behalf of an incoming partner. • Investigation for valuation of shares in private companies. • Investigation on behalf of bank proposing to advance loan to a company. • Investigation of frauds. • Investigation on behalf of a person proposing to buy a business.

INVESTIGATION UNDER THE COMPANIES ACT, 1956

Types	1. Investigation into the affairs of a company and 2. Investigation of ownership of a company.

(A)	***INVESTIGATION INTO THE AFFAIRS OF THE COMPANY***: (Sec. 235 & 237)	
	Who can order investigation & appoint competent investigator	Central Government
	Situation under which it can order investigation (Sec. 235 & 237)	(a) When report from ROC is received u/s 234 or (b) When Tribunal declares that affairs of the company ought to be investigated. (c) When Court Orders Investigation. (Sec. 237) (d) Company passes Special Resolution requiring investigation.(Sec. 237)
	When Tribunal can make such declaration (Sec. 235)	When requisite number of members applies to it.

	Requisite No. in case of a Company (Sec. 235)	***Having Share Capital***	• At least 200 members or • Members holding shares carrying at least 1/10th voting power
		Not Having Share Capital	• Members having at least 1/5th count in Register of Member (i.e. atleast 20 % of members)
	Requirement of application (Sec. 236)		Application to Tribunal must be supported by such evidence as Tribunal may require to satisfy himself that the applicants have good reasons for investigation.
	Circumstances which may make Tribunal feel that investigation is necessary (Sec. 237)		(a) Business of the company is conducted • To defraud its members, creditors & others. • For unlawful/ fraudulent purposes • In a manner oppressive to any of its members. (b) Persons concerned with formation of the company or with management of the affairs of the company are guilty of fraud, misfeasance and other misconduct. (c) Information regarding affairs of the company is not furnished to the members (including calculation of commission payable to MD/ directors).
	Power of inspector to carry investigation into affairs of related companies & persons (Sec. 239)		*<u>Related Companies & Persons</u>* • Companies holding company • Company's subsidiary company • Subsidiary of Company's holding company • Any body corporate in which the company's Manager/ MD is the MD/ Manager • Any body corporate whose BOD consists of Company's nominees. • Any body corporate whose BOD is accoustomed to act in accordance with the instruction of (a) The company (b) The director of the company (c) Any company which has, employees/ nominees of person having control & management of the company – as its director ***Before giving approval CG should give opportunity of being heard to these persons***
	Production of documents & evidence (Sec. 240)		(i) Officers, employees and agents of any person whose affairs are investigated u/s 235,237, 239 should: • preserve & produce all books & papers necessary, and • provide necessary assistance (ii) With the previous approval of CG, the inspector may require any other body corporate to furnish such information, books etc. (iii) Books could be detained only for a period of 6 months. Thereafter, they should be returned. Whenever required, books could be called back. Inspector can examine any person on oath.
	Seizure of documents by inspector (Sec. 240A)		(a) The inspector can make an application to the magistrate of first class or presidency Magistrate if he has reasonable ground to believe that the books and papers may be destroyed, mutilated, altered or secreted. (b) The court may authorize the inspector to seize such books and papers as the inspector considers necessary. (c) The inspector may retain the books and papers till conclusion of investigation.

<table>
<tr><td></td><td>INSPECTOR'S REPORT (Sec. 241)</td><td>(i) <u>Reports</u>
• Interim Report to central government (only when they requires)
• Final Report to central government (mandatory on conclusion of investigation)
(ii) <u>Persons entitled to receive a copy of final report</u>
• Company and body corporate - To be delivered at its Registered office
• Member of the company and Body corporate – On payment of prescribed fees.
• Affected creditors of the Company and body corporate inspected – On payment of prescribed fees.
• Court (u/s 237) & Requisitionist (u/s 235)
<u>Note</u>: CG has the option to publish the report in such manner as it deems fit. Inspector's report may be used as evidence in all legal proceedings.</td></tr>
<tr><td>(B)</td><td colspan="2">INVESTIGATION OF OWNERSHIP OF THE COMPANY SECTION 247:</td></tr>
<tr><td></td><td colspan="2">(i) Central Government has power to order investigation to find:
• The persons, who are financially interested in the Company's success/failure
• The persons, who could control the policy of the Company.
(ii) Central Government can order such investigation on receipt of an order from the Tribunal.
(iii) Central Government should define the scope of investigation i.e. the matters to be investigated and the period to be investigated.
(iv) Those persons who are believed to have beneficial ownership/control over the Company's policy should provide necessary assistance to investigation.
(v) Investigation report – Central Government need not be give the report to any person, if it feels that there exists good reasons for not divulging the contents of the report. Otherwise, it may keep such report with ROC for inspection.</td></tr>
</table>

INVESTIGATION ON BEHALF OF INCOMING PARTNER

<table>
<tr><td>Purpose</td><td>• To know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of existing partners, etc.
• To ascertain whether the capital to be contributed by him would be safe and applied usefully.</td></tr>
<tr><td>Areas to be covered</td><td>a. Ascertaining the history of the firm since inception and growth of the firm.
b. Studies of the provisions of the Deed of Partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, etc.
c. Scrutiny of the record of profitability of the firm's business over a suitable number of years
d. Examination of the asset and liability position to determine the tangible asset, investment, appraisal of the value of intangibles like goodwill, know-how, patents, etc including contingent liabilities and those for pending tax assessment.
e. Assess position of order at hand and the range and quality of clientele should be thoroughly examined under which the firm is presently operating.
f. Scrutinize terms of loan finance to assess its usefulness and the implication for the overall financial position.
g. Study important contractual and legal obligations. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits.
h. Study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation.</td></tr>
</table>

<table>
<tr><td></td><td>i. Ascertain reasons for the offer of admission to a new partner and it should be determined whether the same synchronizes with the retirement of any senior partner whose association may have had considerable impact having on the firm’s successes.
j. Appraisal of the record of capital employed and the rate of returns. It is necessary to have a comparison with alternative business avenues for investments.
k. Ascertain manner of computation of goodwill on admission as also on retirement, if any.
l. Examine whether any special clause exist in the Deed of Partnership to allow admission in future a new partner.</td></tr>
<tr><td></td><td>Previous Years Questions
Q. No. 2: What are the important steps involved while conducting Investigation on behalf of an Incoming Partner? [Nov. 03 (8 marks)]</td></tr>
</table>

INVESTIGATION ON BEHALF OF THE BANK FOR ADVANCES

<table>
<tr><td>Purpose</td><td colspan="3">• Reasons for obtaining the loan
• Determination of Sources of repayment.
• Availability of security, if borrower fails to repay.</td></tr>
<tr><td>Collection of Information</td><td colspan="3">Investigator is required to collect the information w.r.t.
• Purpose for which the loan is required
• Manner in which the borrower proposed to invest the amount of the loan.
• Schedule of repayment of loan submitted by the borrower, particularly, the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case.
• Financial standing and reputation for business integrity enjoyed by the directors and officers of the company.
• Authorisation under Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
• History of growth and development of the company and its performance during the past five years.</td></tr>
<tr><td rowspan="5">Examination of F.S.</td><td>Preparation of a condensed income statement</td><td colspan="2">• From P & L Account for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years.
• Purpose is to ascertain strengths of profitability.</td></tr>
<tr><td>Computation of Relevant Ratios</td><td colspan="2">• Sales to Average Stocks held.
• Sales to Fixed Assets.
• Equity to Fixed Assets.
• Current Assets to Current Liabilities.
• Quick Assets to Quick Liabilities.
• Equity to Long Term Loans.
• Sales to Book Debts.
• Return on Capital Employed.</td></tr>
<tr><td>Break-up of annual sales</td><td colspan="2">Product-wise to show their trend.</td></tr>
<tr><td rowspan="2">Schedule of assets and liabilities</td><td>Assets</td><td>• To ensure their existence, ownership and proper valuation.
• To examine whether assets have been adequately insured.</td></tr>
<tr><td>Liabilities</td><td>• To determine present and future obligations.
• To ensure completeness of recording.</td></tr>
</table>

Previous Year Questions

Q. No. 3: A nationalized bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not. List out the points you will cover in your investigation before submitting your report to the General Manager. [May 03 (16 marks)]

Investigations of Frauds

(A) ***Ways of committing Fraud***

Cash receipts	(i) Issuing a receipt for full amount collected, entering lesser amount on the counterfoil. (ii) Showing a larger cash discount than actually allowed. (iii) Adjusting a fictitious credit in the account of a customer for goods returned. (iv) Cash sales entered as credit sales with debit to customer. (v) Writing off a good debt as bad & irrecoverable to cover up misappropriation of amount collected. (vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount. (vii) Under-casting the receipts side of cash book. (viii) Over-casting the payment side of the cash book.
Cash Payment	(i) Making double payment of an invoice or paying a false invoice. (ii) Paying personal expenses out of the business by falsifying details. (iii) Withdrawing unclaimed credit balances of customers. (iv) Falsely adjusting a refund in the account of a customer and withdrawing the credit balance. (v) Wrong totalling of the wage sheets and misappropriating the excess amount withdrawn from the bank for payment of wages.
Suppliers' Ledger	(i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices. (ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them. (iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them. (iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.
Customers' Ledger	(i) Teeming and Lading. (ii) Misappropriating the amount collected from a customer and subsequently adjusting his account by crediting the amount on account of allowance or a rebate for excess price charged. (iii) Crediting the amount received from a customer to the account of another customer and subsequently withdrawing the amount wrongly credited.
Stock	(i) Employees may simply remove goods from the premises. (ii) Theft of goods may be concealed by writing them off as damaged goods, etc. (iii) Stock records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of stocks in hand.

(B)	**Investigation of Various Frauds**	
	Cash Receipts	(i) Income received from different sources should be scrutinized. (ii) Carbon copies of receipts marked 'duplicate' should be scrutinized. (iii) Examining record of small or negligible sources of income such as sales of scrap or sale of waste paper. **(iv)** Review of recoveries from customers and sundry parties along with deductions on account of cash discounts.
	Cash Payments	(i) Ensure that all payments are properly authorized by competent authority. (ii) Acknowledgement by parties for payments has to be carefully scrutinized and extra care is required where a figure appears to have been erased or altered on such acknowledgement. (iii) Payment by bearer cheques requires careful examination. (iv) Payment as regards wages should be examined for possible over totaling of wage sheets and entries regarding dummy workmen. (v) Payment for goods purchased should be reviewed so as to confirm that no payment has been made in respect of supplies which have not been received. (vi) Any amount paid to partners/directors should be specifically enquired due to possibility of manipulations therein. (vii) Any outgo as regards salaries and wages from Petty Cash Book should be followed up and the Petty Cash Book itself should be vouched and totaled.
	Customers Ledger	(i) Trace the entries in order book with the corresponding record in sales day book. (ii) Examine customer's account to ensure that they have been properly debited at appropriate amount. (iii) The amounts written off as bad debts should be carefully examined. (iv) Any unusual discounts given to them should be thoroughly enquired into and written representation should be obtained from appropriate authority in this connection. (v) Attention should be given to the teeming and leading frauds in such accounts. (vi) Balance confirmation from customers should be obtained.
	Suppliers Ledger	(i) The Bought Journal should be vouched by reference of Goods Inward Book. (ii) Amounts have been correctly credited in respect of goods duly received or not. (iii) Request the supplier to furnish statements of their accounts to find out whether or not any balance is outstanding or due and (iv) Confirm that allowances and rebates given by them is correctly adjusted.
	Stock Defalcation	• Physically check the quantities in stock and those shown by the stock book. • Cross checking of good inward and outward registers along with the purchases and sales day book. • Use of expert advise wherever required.

Previous Year Questions

Q. No. 4: In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify? [Nov. 07 (8 Marks)]

Q. No. 5: Write short note on: Frauds through suppliers Ledger. [Nov. 08 – New (4 Marks)]

Q. No. 6: State the points in an investigation of frauds through suppliers' ledger. [June – 09 Old (6 Marks)]

DUE DILIGENCE

Meaning and Nature	• The term due diligence is often heard in relation to corporate restructuring. • Corporate restructuring may include internal reconstruction, mergers, amalgamations etc. • Due diligence may also be required to be performed in cases of venture capital financing, lending, public offerings etc. • The due diligence is performed to check whether it is advisable to acquire, merge, invest etc.	
Areas in which Due Diligence can take place	***Commercial / Operational due diligence***	To evaluate whether proposed merger would create ***operational synergies***.
	Financial Due Diligence	To analyse books of accounts and other information pertaining to financial matters of the entity.
	Tax Due diligence	To determine the tax affect of the merger or acquisition.
	Information Systems due diligence	To ascertain whether information systems is providing reliable information in an timely manner.
	Legal due diligence	To review legal aspects w.r.t. functioning of the entity and compliance with applicable laws.
	Environmental due diligence	To study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
	Personnel due diligence	To ascertain that the entity's personnel policies are appropriate and suit the requirements of the restructuring.
	Previous Years Questions ***Q. No. 7***: What are the areas in which Due Diligence can take place? [May 08 (5 Marks)]	
Aspects to be covered in Financial due diligence	***Studying the Business History***	• Examine the details of establishment of company. • Details about the original promoters. • Relevant enquiries about the history of business – products, markets, suppliers, expenses and operations.
	Significant Accounting Policies	• Accounting policies followed and its appropriateness. • Examine effect of accounting policies on the overall profitability. • Ascertain changes in significant accounting policies in the recent past, • Areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences.
	Examining Profit and Loss Account	• Examine extraordinary items of income or expense that might have affected the operating results. • Compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. • Compare the trading results and normal operating profit with the trading profits and operating profits of other similar companies. • Based on the trend of operating results, to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business.
	Examining Net worth	• Evaluate the basis upon which assets have been valued and liabilities have been recognised. • The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.

	Payment of Taxes	• Check whether the business is regular in payment of taxes; both Central and State Taxes; • In case taxes are in arrears, check the arrangements made to clear off the arrears.
	Studying the Economic environment	• Study the impact of economic forces at the business. • Examples of economic factors: labour distrubances, changes in government policies etc.
	Cash Flow	• Review historical cash flows and their pattern to determine cash generating abilities. • Check whether the company is able to honour its commitments to its creditors, to the banks, to government and other stakeholders; • Examine how well does the company deploy its funds; • Determine whether any funds are lying idle.
	Financial Projections	• Evaluate the projections for the next five years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. • If assumption used by the company appears to be are unrealistic, consider its impact on the overall valuation of the company.
	Human Resources	• Examine the status of work force, staff and employees and their retention. • Match the job profile of the administrative and managerial staff with the requirements of the new incumbents. • Check the payment of all employee benefits like PF, Gratuity, ESI and superannuation. • Review of pay packages of the key employees.
	Statutory Compliance	• Make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. • If the company has not been regular in its legal compliance, it could lead to punitive charges under the law. • The impact on such violations be quantified and assessed in respect of entity; financial status and even on its going concern status.
Contents of a Due Diligence Report	1. Executive summary. 2. Introduction. 3. Objective of due diligence. 4. Terms of reference and scope of verification. 5. Brief history of the company. 6. Summary on capital structure and group structure of company. 7. Shareholding pattern. 8. Observations on the review. 9. Assessment of Management structure. 10. Assessment of financial liabilities. 11. Assessment of valuation of assets. 12. Assessment of operating results. 13. Assessment of taxation and statutory liabilities. 14. Assessment of possible liabilities on account of litigation. 15. Assessment of net worth. 16. Any liabilities not provided for in the books. 17. SWOT analysis comments on future projections. 18. Status on charges, liens, mortgages and assets of the company. 19. Ways and means to cover unforeseen contingent liabilities. 20. Aspects to be taken care of before/after merger. 21. Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.	

Q. No. 8: Sri Raghav is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. C Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business. What procedures you would adopt before you could render any advice to C Ltd.? [May 02 (10 marks)]

Q. No. 9: An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, what key areas you will cover in your review? List out the contents of your Due Diligence Review Report that you will submit to your USA based Client. [May 03 (16 marks)]

Q. No. 10: Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation. [May 04 (8 marks)]

Q. No. 11: ***Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets. State (in brief) the major areas you would examine for the above. [Nov. 05 (8 marks), Nov. 10 (New) – 5 marks)]***

Answer: Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- Any show cause notice, which have not matured into demands but may be material and important.
- Contingent liabilities not shown in books
- Letters of comforts given to banks and financial institutions
- Company may have sold some subsidiaries / businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- Tax liability under direct and indirect taxes.
- Long pending sales tax assessment.
- Cases of custom duty where only provisional assessment has been made and final assessment is yet to completed.
- Agreement to buy back shares at a stated price.
- Future lease liabilities.
- Claims against the company including third party claims.
- Unfunded retirement benefit of employees.
- Labour claims under negotiations.

Regularly Overvalued assets: The auditor shall have to specifically examine the following areas:

- Uncollectable receivables.
- Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- Obsolete and unused plant and machinery and their spares.
- Assets value which have impaired due to sudden fall in market value.
- Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalisation of revenue expenditure.
- Assets under litigation.
- Investment shown at cost whose market value is much lower.
- Investment carrying very low rate of return.
- Infructuous project expenditure.
- Intangibles of no value.

Q. No. 12: A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify? [May 06 (8 marks)]

Answer: Decline in Net Profits Despite Increasing Sales: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation:

(i) *Unfavourable Sales mix*: Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.

(ii) *Negative Impact of Financial Leverage*: Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.

(iii) *Other Items Included in Sales*: The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.

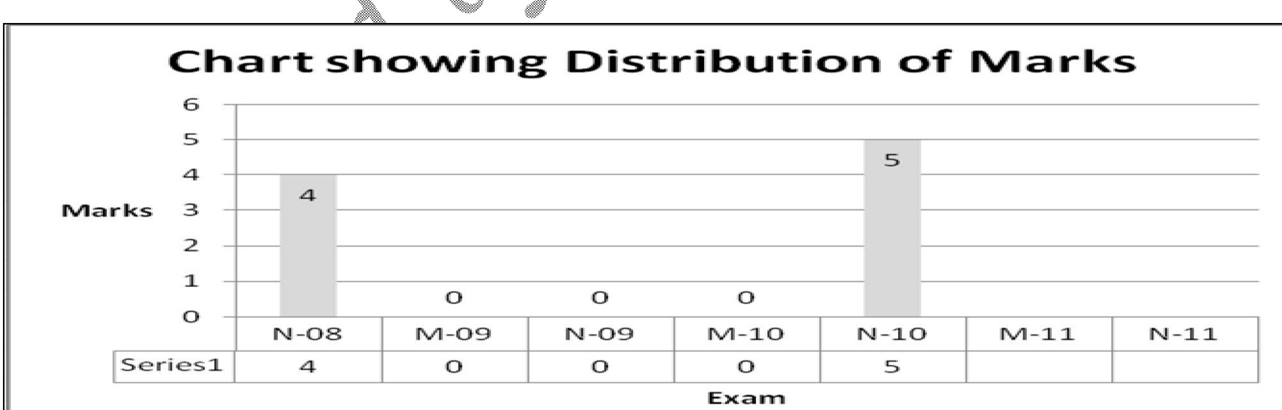
(iv) *High Administrative and Selling Expenses*: Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.

(v) *Cost-Price Relationship*: If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.

(vi) *Competitive Price*: Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.

(vii) Additions to Fixed Assets: Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

Q. No. 13: Write a short note on - Outline the contents of a due diligence report. [May 07 (8 Marks)]



- The term "peer" means a person of similar standing.
- The term "Review" means conduct of re-examination of retrospective evaluation of the subject matter.

Meaning of Peer review	It means review of work done by a professional, by another professional of similar standing. It is a regulatory mechanism for: • monitoring the performance of professionals for maintaining quality of service expected of them, • enhancing the reliance placed by the users of financial statements for economic decision making.	
	Statement of Peer Review of ICAI	• Examination and Review of the • systems and procedures to • determine whether they have been put in place by the Practice Unit • for ensuring the quality of attestation services as envisaged and • implied / mandated by the technical standards and, • whether these were effective or not during the period under review.
Objectives of Peer Review	(1) To ensure that members while performing attestation services comply with technical standards issued by the Institute; (2) To ensure that such a member has in place proper system (including documentation system) for maintaining the quality of attestation services performed by him; (3) To ensure adherence to various statutory and regulatory requirements and (4) To enhance the reliance placed by the users of financial statements for economic decision making.	
	Previous Year Questions ***Q. No. 1***: Explain the objectives of Peer Review. [Nov. 08 – New (4 Marks)]	
Focus of Peer Review	• Compliance with technical standards. • Quality of reporting. • Office systems & procedures w.r.t. compliance of attestation services systems & procedures. • Training Programs for staff (including Articled and Audit Assistants) concerned with attestation functions, including appropriate infrastructure.	
	Previous Year Questions ***Q. No. 2***: Write short note on: Focus of Peer Review. [May 10 – New (3 Marks)]	

Stages of Peer Review

Stage I - Planning	***1. Empanelment of Reviewers***	The reviewer should be member of ICAI having at least 10 years audit experience (cumulative) & currently in practice.
	2. Selection of PU	PUs is selected for Peer review on a random basis as per applicability.
	3. Intimation to Practice Unit (PU)	PU should be informed of in writing of its selection for peer review alongwith a panel of 3 reviewers & a copy of the questionnaire.
	4. Initial communication by PU	PU is required to intimate its ***choice*** of reviewer to Board within ***15 days*** from receipt of information. Within ***1 Month*** of receipt of intimation, PU should send ***completed questionnaire*** along with complete list of client.

	5. Selection of sample Attestation service engagement	should be done by Reviewer on Random basis.
	6. Communication of Sample selection	Reviewer sends a written intimation to the PU about the sample selected by him ***2 weeks in advance*** from the date the reviewer intends to begin review.
	7. Confirmation of visit	Reviewer in consultation with PU fix the dates for ***on site review*** to complete the peer review process in the ***four months*** of receipt of initial intimation to PU.
Stage II- Execution Stage	The execution stage involves the actual conduct of review and, thus, ***begins with initial meeting*** and ***ends with review of records*** by the reviewer.	
	1. Initial Meeting	An initial meeting shall be held between the reviewer and the practice unit to confirm the accuracy of responses to the questionnaire.
	2. Compliance Review	To begin with, the reviewers expected to carry out the compliance review of the key controls, • independence, • maintenance of professional skills and standards, • consultation, • staff selection & supervision and • office administration to gain an understanding of the working of the PU and specific control procedures existing at the PU.
	3. Selection of Attestation Service Engagements	It depend upon: • the number of practicing members involved, • degree of reliance to be placed on general controls and • the total number of engagements undertaken by the PU during the period under review.
	4. Review of Records - Compliance and Substantive Approach	• The reviewer would conduct adequate compliance procedures to gain evidence that those general controls on which the reviewer intends to rely upon, actually exists and functioning effectively throughout the period of reliance. • Based on the results of compliance procedures, the reviewer concludes either to rely or not to rely on the general controls. • In case the reviewer decides to rely on the general controls, he would also need to determine the extent of reliance to be placed on such controls. • In such a situation, the NTE of substantive procedures would be, normally, less extensive and vice-versa. • The substantive approach involves application of such review procedures that provide the reviewer with the evidence as to the appropriateness of the factors on which the review is required to be focused on.

Stage III - Reporting stage in Peer Review	**1. *Preliminary Report of Reviewer***	• At the end of review, the reviewer is required to send a preliminary report to the PU (before making any report to the Board) in case systems and procedures of the PU have been found to be deficient or where noncompliance with reference to any other matter has been noticed by the reviewer. • The report does not contain name of any individual of the PU. • No preliminary report is required in case no deficiencies or non-compliance are noticed by the reviewer. • The preliminary report is addressed to the PU. • The report should also contain a paragraph that discusses the scope of the review performed by the reviewer. • If the reviewer draws a conclusion that there existed a limitation on scope of review, the fact, along with such limitation on the scope of the review, should also be communicated to the PU through the preliminary report. • The reviewer should prepare the report on his letterhead. The report should be dated, signed by reviewer and must have membership number and reviewer's code number allotted by the Board.
	2. *Reply to Preliminary Report*	The PU has to send its representations, in writing, to the reviewer, on the areas mentioned in the preliminary report within a period of ***<u>21 days</u>*** from the receipt of the preliminary report from the reviewer.
	3. *Interim Report of the Reviewer*	• If the reviewer is not satisfied with the reply of the PU, the reviewer has to submit an interim report to the Board. • The report so submitted should clearly indicate that it is an "interim report". • It may be noted that the Board may then give recommendations to the PU and instruct the reviewer to carry out a further review after minimum six months to verify whether systems and procedures have been modified appropriately.
	4. *Final Report of the Reviewer*	The reviewer shall submit his final report to the Board. The final report should incorporate the findings as discussed with the PU.

Previous Years Questions

Q. No. 3: Write short note on: “Reporting stage in peer Review. [June 09 – New (4 Marks)]

PROCEDURES OF REVIEWER

Off Site Procedures	The reviewer would start his review procedures as soon as the PU’s response to the questionnaire is received by him. He should examine PU response so as to: • Determine initial sample of the clients to whom attestation services have been rendered. • Obtain a basic understanding of quality control policies and procedures of the PU. • Develop an appropriate plan to conduct review in an effective, efficient and timely manner.
On Site Procedures	• To have a Initial Meeting with PU. • Evaluation of PU’s policies and procedures: • Compliance & Substantive Testing

COMPLIANCE REVIEW PROCEDURES

Independence	• Does the PU have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy? • Does the PU communicate these policies and the expected standards of professional behavior to all staff? • Does the PU monitor compliance with policies and procedures relating to independence? • Does the PU periodically review its association with clients to ensure objectivity and independence?
Professional Skills and Standards	• Does the PU have an established plan for personnel needs at all levels, based on current and anticipated clientele, business growth, impending retirements, etc.? • Does the PU have an established recruitment policy? • Are applicants and new personnel informed of the personnel policies and procedures relevant to them? • Does the PU have continuing education programmes for partners and staff? • How easily are current and relevant professional literature, including accounting and auditing standards and pronouncements by professional bodies, available to partners and staff? • Does the PU conduct programmes for developing expertise in specialized areas and industries?
Outside Consultation	• Is there any policy for consulting experts (both internal and external)? • Has the PU built up a network of other accountants, solicitors and advocates, and technical consultants in industries in which its clients operate?
Staff Supervision and Development	• Does the PU have written guidelines on the responsibility at each level, and on the expected performance and qualifications necessary for advancement to the next level? • Does the PU have a system for gathering and evaluating information on the performance of personnel? • Does the PU have a system of assigning an audit to the most appropriate personnel? • Are requirements of specialized expertise and personnel skills given due consideration? • Does the PU have written guidelines for maintaining working papers (form and content)? • Does the PU have standardized forms, checklists, questionnaires to assist conduct of audit?
Office Administration	• Does the PU have established procedures for record retention, including security aspects? • Does the PU maintain a record containing particulars like client name, nature of engagement, particulars regarding date of commencement of audit, date of audit report, billing, etc? • Does the PU maintain staffs register? • Does the office have a proper library containing relevant book and all publications of ICAI.

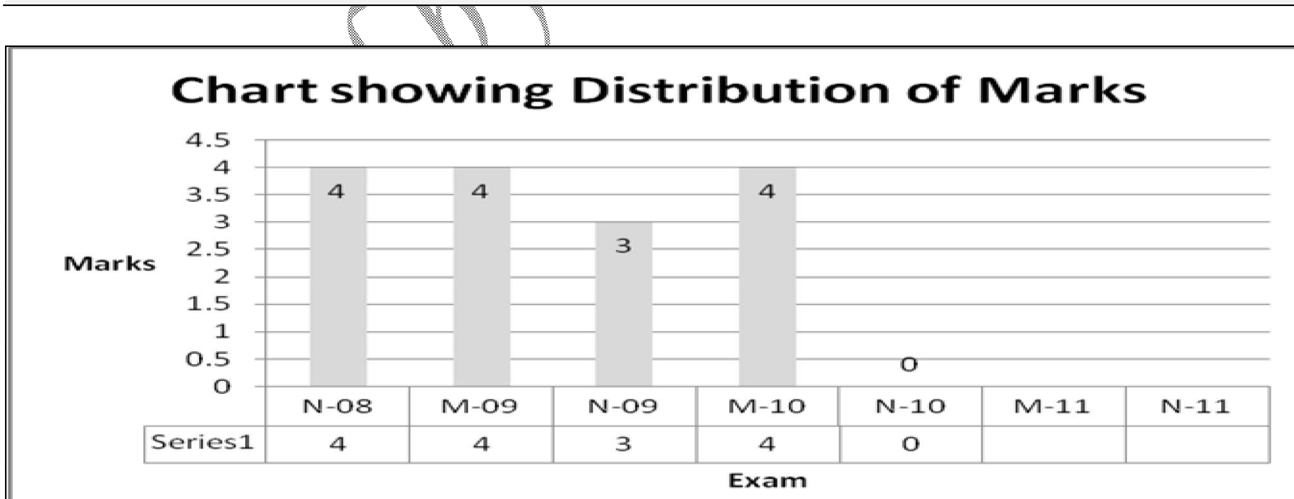
MISCELLANEOUS

REVIEW OF RECORDS	After evaluating general controls by performing compliance procedures, the reviewer review the records of the PU. Such review may either be conducted by compliance approach or substantive approach or a combination of both. At the first stage, the records in respect of following key controls are to be reviewed to ensure compliance with technical standards:

	• Audit Record Administration • Financial Statements Presentation • Review and Evaluation of System of Internal controls • Substantive Tests • Audit Conclusion • Audit report
Evaluation of Quality of Reporting	1. The reviewer should verify whether the PU has policies and procedures, to provide reasonable assurance that the reports issued are supported by conclusions reached. 2. The reviewer should determine the level of supervision of the engagement under review, by examining the following: • Complexity of the subject matter; • Qualifications of persons performing the work; • Extent of consultation available and used; • Degree of authority delegated to assistants on an engagement; • Performance of personnel assigned to an engagement; and • Risk inherent in the engagement. 3. The working papers of the PU must contain adequate evidence to support the audit opinion. 4. The auditor's report should contain a clear expression of opinion on the F.S.. 5. The reviewer should ascertain that principles relating to the manner of qualifying the audit report have been complied with.
Collection of Evidence by Peer Reviewer	A Peer Reviewer collects evidence by applying the following methods: (a) *Inspection*: It includes scrutiny of documentation and other records of the practicing unit. (b) *Observation*: He observes the procedures/processes followed in the production unit. (c) *Enquiries*: He enquires and collects required information from the responsible person of practice unit, even by the use of questionnaire.

Previous Years Questions

Q. No. 4: Briefly explain: Collection of evidences by Peer reviewer. [Nov. 09 – New (4 Marks)]



SARBANES OXLEY ACT 2002

The *Public Company Accounting Reform and Investor Protection Act of 2002* is commonly called SOX or Sarbanes – Oxley Act. It is a United States federal law passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom which have resulted in a decline of public trust in accounting and reporting practices.

This Act establishes new or enhanced standards for all U.S. public company boards, management, and public accounting firms. The Act plays a vital role in the globalised environment of Financial Reporting, Auditing and corporate Governance.

Major Provisions of SOX Act:

1. Creation of Public Company Accounting Oversight Board (PCAOB).
2. More independence be given to Audit Committee and auditor.
3. Ban on personal loan to Directors / Executive Officers of a Company
4. Strict reporting by an auditor on insider trading.
5. Additional disclosures imposed on financial reporting.
6. If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
7. Higher penalties and criminal prosecution on financial frauds.
8. To include effectiveness of Internal Control System in the financial reporting.
9. More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.
10. Strict action against white collar crime.
11. Disclosers of the % of shareholdings by Directors, Executive Officers and principal shareholders.

Corporate Responsibility under Sarbanes Oxley Act of 2002	(a) The audit committee to be more independent through enhancement of their over sight responsibilities and one of the Audit committee members to be financial expert. (b) Requires CEO& CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance. (c) Provides rules of conduct for companies managerial and their officers regarding Pension matters. (d) To Comply with SEC rules requiring attorneys to report violation of securities laws to the company's CEO or chief legal counsel & to Audit Committee if no action is taken.

Previous Year Questions

Q. No. 1: Highlight the provisions relating to corporate responsibility under Sarbanes Oxley Act of 2002. [Nov. 08 – New (4 Marks)]

Q. No. 2: State briefly eight provisions of the Sarbanes-Oxley Act of 2002, which shall, if strictly applied to Indian Corporates, get fruitful results. [Nov. 09 – New (8 Marks)]

Q. No. 3: "Corporate accountability and civil and criminal penalties for white collar crimes". Comment on the major provisions of Sarbanes Oxley Act. [Nov. 10 – New (5 marks)]

DISCLOSURE CONTROLS AND PROCEDURE

Nature and Purpose	They are meant to ensure that all the information required by law to be included in the periodic reports filed with the SEC is made available to those responsible for preparing them in a complete and timely manner. They should be crafted in such a way that they are easy to follow and practical to implement. They should be in writing and should be customized to reflect the operations of the company and its particulars risk profile.	
Suggestions for implementation of Disclosure and Control procedures	**(a)** ***Disclosure Committee***	• A disclosure committee may be established charged with assisting the CEO and CFO in developing, writing and overseeing Disclosure Controls and Procedures.
	(b) ***Inventory of Current Procedures***	A good starting point for the disclosure committee in developing Disclosure Controls and Procedures is to take an inventory of the company's existing practices and weaknesses with regard to: • preparing annual reports; • the handling of whistle blower complaints with, respect to the company's disclosure; • the review of any matters raised by the company's independent auditors, and • the retention of relevant documents.
	(c) ***Identification of personnel***	• The disclosure committee should identify persons both inside and outside the company whose input is critical to the disclosure process.
	(d) ***Preparation of Controls and Procedure Check list***	• The disclosure committee should disseminate internally a Control and Procedures check list which fills in any gaps and fixes any weaknesses discovered by the inventory.
	(e) ***Back-up Certifications***	• Companies may wish to consider obtaining "back-up" support certifications from certain officers that confirm the certifications of the CEO and CFO.
	(f) ***Other functions of Disclosure Committee***	• Overseeing and coordinating the collection of information. • Resolving questions about the materiality of a development • Reviewing and advising on the content of disclosure • Drafting of disclosure and communication with the investing public. • Recommending to the board, the audit committee, the CFO and the CEO on the filing of the report.

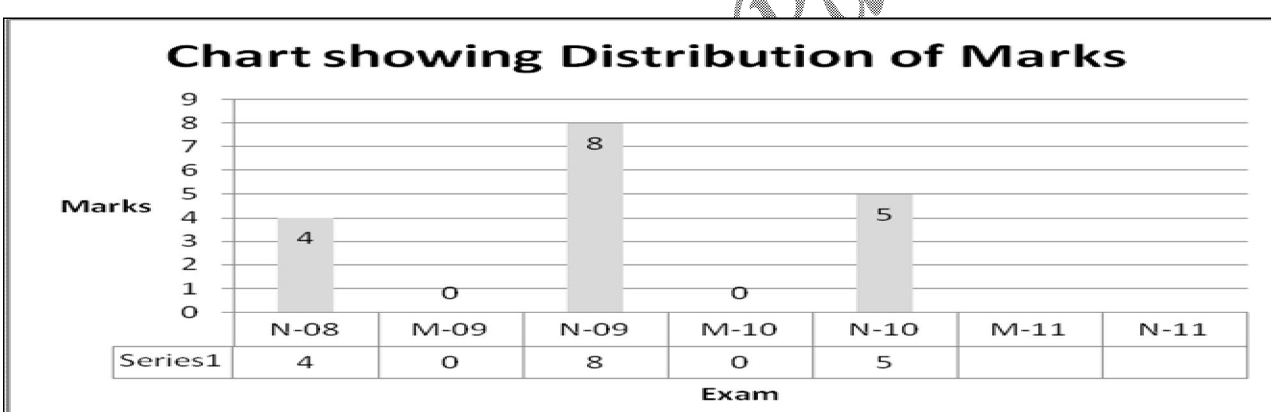
Internal Control over Financial Reporting

It is meant to ensure the integrity of the F.S. and guard the assets of the company in the following levels:

(a) *At the bookkeeping level*: to enforce the proper recording of income & expenditure so that revenues are deposited into the company's bank account and unauthorized expenditures do not leave the company's bank account.

(b)) *At the executive level*: to prevent manipulation of revenues and expenses, such as illegal transfers from expense accounts to capital accounts, in which management may be tempted to show higher profits.

Procedures to Be Included In the Internal Control over Financial Reporting	Internal Control Over Financial Reporting should include policies and procedures that provide reasonable assurance that: • records are maintained that fairly reflect purchase and sales of the company's assets, • that transactions are properly recorded so as to financial statements as per GAAP, • receipts and expenditures are being made in an authorized fashion and • timely detection of unauthorized use of company assets.
Extent of Management's Duty to Assess and Report on the Company's Internal Control Over Financial Reporting	• Management is required to evaluate the effectiveness of those controls on a periodic basis and to include a report of such evaluation in the annual report, which evaluation must be attested to by the company's outside accountants. • It must be free from bias. • If management discovers any deficiency in the design or operation of Internal Control Over Financial Reporting that could adversely affect a company's ability to record, process, summarize and report financial data, then management must disclose this material weakness in the report.
Documentation	• Management should maintain the documentation that supports its assessment of the effectiveness of the company's internal control over financial reporting.
Note: Management can not delegate the evaluation of internal control over financial reporting to company outside accountants.	



ENVIRONMENT AUDIT

Meaning	It is a critical analysis of the following aspects that relate to the environment like – (i) Policies (ii) Principles (iii) Systems (iv) Procedures (v) Practices (vi) Performances	
Areas of Environmental Audit	1. ***Layout and Design***	Examine the followings: • Installation of Pollution Control devices. • Provisions for up gradation of Pollution Control measures to meet requirement of regulation framed by Govt.
	2. ***Management of Resources***	• It include air, water, land, energy, raw materials & human resources. • Examine that these resources are best used with minimum waste.
	3. ***Pollution Control System***	• Examine existence of Pollution control System. • Inquire whether more measures are required, keeping in view the type of industry and its nature or working.
	4. ***Emergent Safety Arrangement***	• Examine *existence and adequacy* of safety arrangements.
	5. Medical & Healthcare facilities	• Examine *existence and adequacy* of Medical and healthcare facilities.
	6. Industrial Hygiene	• Examine existence of proper system to ensure hygienic environment.
	7. Occupational Health	• Examine the focus of industry to the diseases which are prone to that particular type of industry.
	8. Information Assimilation and Reporting system	Examine the followings: • Generation of information required under Environmental Laws. • Preparation of Compliance Report w.r.t. environmental laws along with other preventive and precautionary measures at regular internals.
	9. Environmental Impact Assessment (EIA) Methodology	• It is a prerequisite to start an industry. • Examine whether the EIA Report accommodates the deviation expected.
	10. Compliance to the Regulatory mechanism	• Examine whether a system exists to trained & instruct the staff on regular basis, to avoid making the Board/Owner liable to prosecution and penalty.
	11. Concern of the society	• Examine how the industry is making a balance between its own development and the society's concern.

Format of Environment Statement	(a) Name/address of owner/occupier of the industry, operation or process. (b) Date of last environmental audit report submitted (c) Consumption of water and other raw materials as input during current and previous year. (d) Pollution generated in air and water with output and types of pollutants and deviation from standard. (e) Generation of hazardous waste in current year and previous year from processes or from pollution control facility. (f) Quantity of sold waste generated during current year and previous year from process/es from pollution control facility and from recycling or reutilization of waste, etc. (g) The disposal practice for different type waste. (h) The practice of conservation of natural resources. (i) The additional investment proposal for environmental protection including abatement of pollution
	Previous Years Questions ***Q. No. 1:*** What are the areas to be considered in an Environment audit? [Nov. 08 – Old (8 Marks)] ***Q. No. 2:*** Write short notes on: Probable format of Environmental Statement. [June 09 – New (4 Marks)]

ENERGY AUDIT

Meaning	It is an activity that assesses energy use pattern of a factory/ energy consuming equipment and identifies saving opportunities.
Key functions of the Energy Auditor	(i) Quantify energy costs and quantities. (ii) Correlate trends of production or activity to energy costs. (iii) Devise energy database formats to ensure they depict the correct picture – by department, consumer, product, etc. (iv) Advise and check the compliance of the organisation for policy and regulation aspects. (v) Highlight areas that need attention for detailed investigation. (vi) Conduct *preliminary and detailed energy audits* which should include the following: (a) Data collection and analysis (b) Measurements, mass and energy balances. (c) Reviewing energy procurement practices. (d) Identification of energy efficiency projects and techno-economic evaluation. (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates. (f) Recommendation on goal setting for energy saving, record keeping, reporting and energy accounting, organization requirements, communications and public relations.
	Previous Year Questions ***Q. No. 3:*** Enumerate some of the key functions of the Energy Auditor. [May 07 (8 Marks)] ***Q. No. 4***: Write short note on: Energy Audit. [May 10 - Old (4 Marks)]

MUTUAL FUNDS

Contents of audit Report	The auditor's report of mutual funds shall comprise the following: (1) He has obtained all information and explanation which, to the best of his knowledge and belief were necessary for the purpose of audit. (2) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus/ deficit in the fund for the accounting period to which the balance sheet or, as the case may be, the revenue account relates. (3) The statement of account has been prepared in accordance with accounting policies and standards as specified in the Ninth schedule prescribed by SEBI (MF) regulations, 1996.
	Previous Years Questions ***Q. No. 5***: What shall comprise the auditor's report of Mutual Funds. [June 09 – Old (4 Marks)]

AUDIT OF MULTIPLEX THEATRE

1. Peruse the MOA and AOA of the entity.
2. Ensure the object clause permits the entity to engage in this type of business.
3. In the case of ***income from sale of tickets***:
   (a) Verify the control system to ensure that the collections on sale of tickets are properly accounted.
   (b) Verify the system of on line booking of various shows and the system of realization of money.
   (c) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
4. Verify the internal control system and its effectiveness relating to the ***income from cafes shops, pubs etc***., located within the multiplex.
5. Verify the system of control exercised relating to the ***income receivable from advertisements*** exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
6. Verify the system of ***collection from the parking areas*** in respect of the vehicles parked by the customers.
7. In the case of ***payment to the distributors*** verify the system of payment which may be either through out right payment or percentage of collection or a combination of both.
8. Verify the system of ***payment of salaries and other benefits to the employees*** and ensure that statutory requirements are complied with.
9. Verify the payments effected in respect of the ***maintenance of the building*** and ensure the same is in order.

Previous Years Questions

Q. No. 6: You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure. [Nov. 08 – New (8 Marks)]

AUDIT OF DEPOSITORIES

Purpose of Appointing Inspectors	SEBI appoints inspecting officers to investigate or inspect the affairs of a depository for any of the following purposes. (1) To ensures that the books of accounts are maintained in the names specified in the regulations (2) To look into the complaints received from depositors' participant, beneficial owners or others. (3) To ascertain whether the provisions of the Act, bye-laws, regulations are being complied. (4) To ascertain whether the systems, procedures and safeguards are being followed in the interests and to secure the market. (5) To ensure that the affairs are being conducted in the interest of Investors / Securities markets.
	Previous Years Question ***Q. No. 7***: Purpose of appointing Inspecting officer of a Depository. [Nov. 08 – New (4 Marks)]